Risk management and how ESG fits into the equation

By Siphokazi Kayana and Charlene Ferns

27 Mar 2024

For almost as long as businesses have existed, so has some level of risk management. Risk management encompasses identifying, assessing and controlling financial, legal, strategic and security risks within a business.

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After all, businesses that could best identify any inherent risks and dangers and put strategies and mechanisms in place to mitigate them have always been the ones most likely to achieve long-term success within any economy. But what risk management means has changed over the years.

While it is still important for businesses to anticipate and manage things like market, operational, and financial risks, they increasingly have to manage other forms of risk too. An example of these risks include events such as the Covid-19 pandemic, Russia's war in Ukraine, and the ongoing crisis in the Middle East, which have highlighted how significant supply chain risks can be.

Even things that were once considered "nice-to-haves" should now fit into risk management frameworks. Take ESG, for example, which essentially are a set of standards involving environmental, social and governance. While governance (the G in ESG) has always fitted neatly into risk management, environmental (the E) and social (the S) initiatives have traditionally been seen as positive additions or "nice-to-haves".

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Overcoming ESG's investment shortcomings

ESG is viewed as an investment incentive. The idea behind it is that companies can profit while acting as a net positive for the environment and the societies they operate in, and should be incentivised for doing so by investors.

After the initial flurry of interest, in which ESG-led funds and indexes performed well, it's becoming increasingly apparent that the concept isn't delivering on its initial promise. A lack of clarity around ESG and a lack of uniform metric, rules and regulations have only contributed to a sense of disillusionment among investors.

There is further a lack of evaluation and monitoring of ESG criteria within South Africa, as compared to other countries such as those within the European Union, who have recently enforced mandatory ESG reporting standards.

Some have also argued that ESG, in its investment form, hasn't achieved its goal, and has in some instances encouraged poor behavior in businesses trying to "meet" the score for green standards (ie. greenwashing). Environmentally, for instance, it's been alleged that it rewards companies which were already green while providing few incentives for big polluters to change their practices.

Bringing balance through risk management

None of that, of course, is to say that investment-based incentives can't be a powerful tool for change. They can be. And if the ESG investment space can find solutions for its current issues, it could well change the way businesses operate so that they really are good for people and the planet.

But it can't achieve that on its own. Businesses also need to understand the costs – seen and unseen – associated with poor ESG practices. Moreover, they need to understand the risks posed by those practices and how to manage them.

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In some cases, those risks are easily observed. The billions of rands of damage done by the KwaZulu-Natal floods of 2022 and the Western Cape floods of 2023, for example, showed how unprepared businesses were for that kind of catastrophe. The 2021 riots that rocked KwaZulu-Natal and Gauteng, meanwhile, showed how costly social neglect by both the state and private sectors can be.

Others are less visible but equally damaging. A good example of this is air pollution. A [report published in November 2023] found that air pollution in just six African cities, including Johannesburg, will come with an economic cost of $137.8bn from 2023 to 2040 in a business-as-usual scenario. That's to say nothing of the sick days that businesses have to deal with thanks to illnesses associated with air pollution.

Governance, meanwhile, should always be in the purview of risk management. In any society where the rule of law is strong, governance failures should rightfully be seen as a massive risk.

Beyond the balance sheets

Ultimately, businesses must understand that while the ESG risks might not be reflected in their bottom lines right now, they very likely will in the long run. As such, it may be critical that they view ESG considerations from a risk management perspective rather than simply an investment one.

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