ESG Integrity: A New Benchmark for Corporate Responsibility

Environmental, Social and Governance (ESG) benchmarks require a business transformation. The world is facing unprecedented temperatures, species are getting extinct, and we face a tremendous challenge to change the tides. Corporates and financial institutions play a key role to make the necessary impact. Companies face risks, including financial and integrity risks, but on the other hand, business opportunities are luring. In this blog we explain the different types of risks and conclude that by managing such risks properly businesses secure their future while making a positive impact.

Double Materiality: Understanding Sustainability from an Impact and Financial Perspective

Companies and financial institutions need to act in a sustainable way otherwise this can have negative impact on ESG topics and/or can have financial implications for the organisation itself. A sustainability topic is material from an impact perspective if the organisation is connected to significant impacts on people or the environment related to the topic over the short, medium or long-term. A sustainability topic is material from a financial perspective if it triggers financial effects on organisations, i.e., generates risks or opportunities that are likely to influence the future cash flows in the short, medium or long-term. Looking at sustainability in both ways is called the “double materiality”.

As part of the Green Deal, EU regulations were created on how to identify and manage sustainability from a double materiality perspective and how to report, for example regulations such as the EU Taxonomy, the Corporate Sustainability Due Diligence Directive (CSDDD) and the Corporate Sustainability Reporting Directive (CSRD). Such regulations can be used as a toolkit to integrate sustainability in business models.

Navigating ESG Integrity: Addressing Risks and Civil and Criminal Liabilities

Many businesses start realising the financial impact of sustainability risks and focus on ESG reporting obligations but are not yet properly managing the risks of ESG-related misconduct and its connection to civil and criminal liability, which can discourage ESG commitments.

Deloitte's recent whitepaper, "Managing and Mitigating ESG Integrity Risks," explores the increasing responsibilities businesses face regarding their societal impacts. It also discusses the connections between ESG-related misconduct and civil and criminal liability, such as financial crime. The insights from risk management are foundational for strategic decision-making and identifying business opportunities.

EU regulations, including the CSRD and the CSDDD, broaden the responsibility for ESG-related misconduct among financial institutions and corporates. Additionally, the growing criminalisation of ESG-related offenses, especially environmental crimes, leads to enhanced Duty of Care requirements for businesses.

The expanding regulatory scope is preceded by rising societal expectations. Companies are increasingly held accountable for enabling environmental or social offenses, or for failing to act against environmental damage and breaching duty of care. For instance, The Hague District Court required Royal Dutch Shell PLC, directly and through its group companies, to reduce carbon emissions by 45% by 2030 from 2019 levels.

Environmental Crimes: The New Frontier in Anti-Money Laundering Efforts

The new Environmental Crime Directive that entered into force on 20 May 2024, has increased criminal offence categories and strengthened the penalties and sanctions for offenders. Next to illegal pollution of air, soil or water, violations of waste regulations, and illegal wildlife trafficking, offences such as illegal timber trade and serious breaches of EU chemicals legislation and pollution caused by ships have been added.

Financial institutions and corporates often underestimate the increasing regulatory focus on the money laundering risks associated with environmental crime proceeds. The Financial Action Taskorce (FATF) identifies environmental crime as one of the most profitable criminal activities, posing a substantial risk for generating profits that could be laundered through the financial system. Recently, a group of NGOs have filed a criminal complaint against French banks for laundering the proceeds of environmental crime.

With the classification of environmental crime as a predicate offense for money laundering, it's clear that the EU expects a more proactive and targeted approach to combat these crimes. Consequently, both financial institutions and corporate entities face the risk of unintentionally facilitating money laundering from ESG-related crimes, including human rights violations like human trafficking and labour exploitation, as well as environmental crimes.

Uncharted Risks: Vulnerabilities to ESG-Related Crimes

Financial institutions may face civil or criminal liabilities if they fail to recognise their exposure to ESG integrity risks, such as environmental crime. Many have not made identifying these risks a priority. A recent WWF survey highlighted widespread gaps in knowledge and vulnerabilities in the global financial system, particularly in managing proceeds from land conversion and illegal deforestation. Nearly half of the surveyed institutions operate in high-risk sectors, yet over a quarter have not conducted specific environmental or human rights due diligence. With increasing regulatory obligations in ESG, businesses are more exposed to potential ESG-related misconduct, civil and criminal liabilities. For example, financial institutions are increasingly exposed to the risk of laundering the proceeds of environmental crime..

The potential risks of inadvertently facilitating money laundering extend beyond financial Institutions and encompass various corporate entities involved in diverse sectors. Not only financial flows, but also the flow of goods, can potentially have an illegal origin, thereby acting as conduits for money laundering. Failing to conduct adequate Supply Chain Due Diligence can lead to a situation where a corporation unwillingly handles the proceeds of environmental crimes or human rights violations. This might result in allegations of culpable money laundering if corporates could have known about the illicit origins within their supply chain if they had properly performed their supply chain due diligence processes.

Strategising ESG Integrity: Beyond Regulatory Compliance to Proactive Engagement

The pressing question is how to effectively mitigate ESG integrity issues and prevent the facilitation of ESG-related crimes. Due diligence is a crucial starting point, as it sets the baseline of where parties stand and what possible risks there are. ESG integrity risk management should not be treated as merely a checkbox exercise; it can be seen as ensuring a healthy future both from an impact as financial perspective. A strategic approach to ESG integrity involves proactive engagement with regulatory developments and thorough assessment of internal operations and business activities, as well as business relationships throughout the value chain(s). The information collected through due diligence and risk management processes is essential for defining transition pathways, setting targets, engaging with suppliers and clients, and strategically achieving ESG goals.

Due diligence should be a dynamic tool that extends beyond standard checks for business partnerships. It should identify and mitigate risks connected to environmental harm, human rights impacts and illicit activities, serving as a foundation for sustainable transitions. Companies need to be proactive, anticipating ESG risks and opportunities and integrating preventive measures into their business models. This robust approach to due diligence ensures that ESG considerations are central to risk management and inform business decisions at all levels.

Looking Ahead

Despite the challenges, parties need to step up their efforts in mitigating and managing ESG integrity risks. The risk of inaction far outweighs the imperfections of proactive steps. This perspective is essential not only from a regulatory standpoint but also for long-term business perspective. Ultimately, the objective is not merely to fulfil compliance checklists or evade all risks, but to genuinely create a positive impact! Companies committed to this approach are less likely to face litigation or financial crime issues.

ESG Integrity Blog Series

Stay tuned for our upcoming blogs, in which we will further explore the dynamic regulatory landscape and the need for setting up an ESG Integrity governance, and which underscore the importance of embedding ESG factors within risk assessments to ensure robust, future-proof business practices. Additionally, here you will find our solution on managing and mitigating ESG integrity risks.

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