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ESG Concept as the Newest Determinant of Corporate Risk Management Strategies of Multinational Enterprises

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ABSTRACT

Within the rapid development of the world economy in recent decades, the growth of stable financing, including the increase in the number of relevant financial products, the attention of investors, politicians and various stakeholders in civil society has been drawn to the potential of multinational enterprises (MNE) to bring financial returns in accordance with social values and to make their contribution to overall macroeconomic stability and the fight against climate change. In particular, investing according to the concept of environmental, social and governance (ESG) has become a leading form of sustainable financing and has moved from early stages of development to mainstream financing in a number of leading countries. ESG ratings applied to MNE, which accounted for about 80% of the global economy's market capitalization in 2020, have evolved in recent years to incorporate long-term financial risks and opportunities into investment decision-making processes.

An effective risk and opportunity management system, as well as appropriate risk management strategies, are an important component of the effective implementation of the ESG concept in the activities of MNE. A significant role is played by the risk management system of MNE in the areas of environmental factors (environmental) and the latest system of corporate governance (governance).

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1. INTRODUCTION

Environmental, social, governance (ESG) investing has become the leading form of sustainable financing for multinational enterprises (MNE) in the energy sector and has moved from early stages of development to mainstream financing in a number of leading global economies. Forms of ESG investing have grown to nearly $40 trillion [1], which generally refers to the process of considering environmental, social, and corporate governance factors when making investment decisions [2]. ESG ratings, which are now applied to MNE, which accounted for about 80% of market capitalization in 2020, have evolved in recent years to incorporate long-term financial risks and opportunities into investment decision-making processes.

The growing use of ESG, from ratings to investment approaches, is drawing attention to the extent to which the environmental component of ESG offers an effective measurement of environmental impact, carbon emissions and green investments. As MNE market participants show greater awareness and concern that climate risks may have consequences for the long-term value and financial stability of the enterprise, the concept of ESG is increasingly being used to assess MNE commitments and actions towards the transition to renewable energy sources and green products. To meet this demand, asset managers and ESG rating providers are increasingly integrating multiple metrics into ESG assessments and investments.

ESG disclosures, appropriate ratings and investment approaches are becoming an increasingly important tool for integrating sustainability considerations into MNE investment processes and can serve to support investors in making informed decisions and value judgments regarding asset allocation. If they meet the objectives, ESG methods can help financial investors who seek to assess the financial sustainability of MNE with respect to conditions, practices and strategies related to environmental, social and governance risks and challenges in the medium term [3]. That is why an effective MNE risk management system must take

into account ESG requirements and take into account the impact of climate change and other sustainability risks on MNE corporate performance over time, as well as transition to renewable energy strategies that can create new growth opportunities over time.

2. GENESIS OF THE ESG CONCEPT

The concept of Corporate Social Responsibility (CSR) can be considered a precursor to the emergence of the ESG concept in the system of international economic relations. CSR was an initiative often supported by MNE activist employees and consumers, which scrutinized issues such as MNE carbon footprint and ethical supply chains. However, for most organizations this was not considered a primary business goal and was not formally regulated. Many MNE have corporate social responsibility programs that share some similarities with ESG, but differ in certain ways. While ESG and CSR activities are corporate, CSR initiatives are voluntary and generally focus on improving MNE relationship with external stakeholders. ESG programs are typically implemented as part of a broader corporate strategy to meet investor or regulatory requirements. MNE managers use CSR within the framework of corporate philanthropy or partnership with public groups, using in their work the international standard ISO 26000 with recommendations on social responsibility [4].

The concept of ESG attracted the attention of the world economic community after the report "Who Cares Wins: Connecting Financial Markets to a Changing World" that was published in 2005 under the auspices of the United Nations [5]. The report argued that introducing ESG considerations into capital markets would lead to better societal outcomes. Subsequently, the UN developed the document "Principles for Responsible Investment (PRI)" as a standard for a sustainable global financial system. Since 2006, PRI signatories have grown from 63 with $6,5 trillion in assets under management to over 3 800 signatories with $121 trillion in assets under management [6].

On May 24, 2018, the European Commission adopted a package of measures on sustainable financing. This package included proposals aimed at creating a unified EU classification system for sustainable economic activities (the "Taxonomy Regulation"), improving ESG disclosure requirements to facilitate informed decision-making by investors (the "Disclosure Regulation") and creating a new category of benchmarks, which will help investors compare the carbon footprint of their investments [7].

3. CORRELATION BETWEEN BUSINESS OPERATIONAL EFFICIENCY AND ESG IMPLEMENTATION IN MNE

During the last decade, a number of researchers have studied the correlation between the operational efficiency of business and the implementation of the ESG concept in the activities of MNE. In 2020, the French economist Riccardo Boffo conducted an analysis of MNE profitability in relation to ESG, adjusted for risk [8]. The results of the analysis indicate the dependence of the MNE ESG rating scores and the investment strategy used, which raises questions about the true extent to which ESG contributes to performance. As part of the research, Boffo tested investment fund benchmarks and performance against several prominent industry databases, evaluating several strands of portfolio theory to understand how integrating ESG factors into the investment process affects performance and volatility compared to traditional investments. The results show a wide range of ESG investment financial performance across indices, portfolios and investment funds.

The integration of the ESG concept can have a number of impacts on the operational and financial performance of MNE, leading to both over- and under-performance compared to market returns. On the one hand, a number of studies indicate that certain aspects of basic ESG factors can have a positive impact on MNE corporate financial performance over time due to improvements in corporate governance and risk management. On the other hand, there is a growing number of studies observing the market underperformance of ESG-focused indices and portfolios compared to traditional (ESG neutral) market portfolios, which reduces risk-adjusted returns [9].

Boffo's research suggests that ESG approaches have yet to deliver sustainable benefits in productivity and operational efficiency based on absolute return and Sharpe ratios. At the same time, on the other hand, they help to reduce the impact of catastrophic risks on MNE according to the assessment of "tail" risk of the normal distribution during a certain period of time. This thesis is confirmed by the operational efficiency indicators of a number of MNE that implemented the ESG concept during the market tension associated with the COVID-19 pandemic, which indicates relative resistance to the materialization of "tail" risks [10, 11]. This indicates the acquisition of MNE implementing the ESG concept in their activities, features of stability and resilience to systemic macroeconomic and geopolitical risks.

In the current environment of high global financial and geopolitical volatility, the implementation of the ESG concept becomes an integral part of MNE activities, which aims to improve corporate risk management practices and, in turn, increase risk-adjusted returns, as MNE's investors and stakeholders start to understand better the factors that can affect climate change, social issues such as human rights and occupational health and safety. It is extremely important to build interaction between ESG approaches and strategy for the harmonious integration of the ESG concept into the operational activities of MNE.

4. CORRELATION BETWEEN THE ENVIRONMENTAL COMPONENT OF THE ESG CONCEPT AND THE LOW-CARBON TRANSITION

In recent years, many governments, international organizations and private institutions have focused their efforts on analyzing risks and opportunities of the transition to a low-carbon economy, including assessment of the implications on the global financial system. Crucially, for such transitions to occur in an orderly manner through financial systems, financial markets will require efficient capital allocation, risk assessment and transfer, and pricing facilitation to reduce the risks of abandoned assets and obsolete production processes, and to support the necessary investment in renewable energy sources, efficient production processes and "green" technologies.

Today, leading MNE are incorporating ESG approaches into their risk management strategies, with some also using environmental "E" scores as a tool to better align portfolios with the low-carbon transition. In this regard, an "E" score in ESG ratings is increasingly being considered to assess and rebalance investors' portfolios to better align them with climate risks and opportunities. A number of central banks are also in the process of integrating ESG assessments into investment approaches as one of several tools used to align with the transition to a low-carbon economy [12].

The ESG ratings combine a wide range of MNE's environmental impact and climate-related factors into a single "E" score. On the one hand, they include an assessment of the "E" indicator related to climate change, such as energy efficiency, carbon footprint and intensity, climate risk mitigation and renewable energy strategies. On the other hand, they also integrate broader environmental impact indicators such as biodiversity, water use and waste management. Importantly, the level of reporting by each MNE (i.e., disclosure of qualitative or quantitative factors) and how the rating providers then collect and aggregate this information (i.e., weighting, use of binary measures and construction of composite scores) will affect the final "E" score. It is also relevant to note that the risks associated with the transition to a carbon-neutral economy will become more financially significant over time and will contribute to the long-term (including financial) value of MNE as physical climate impacts become more widespread, harmful or costly, and climate policy and regulation are becoming more ambitious, which must be taken into account when building a risk management strategy.

Table 1. Below shows the matrix of methodological approaches to the assessment of the "E" indicator [9].

№	Methodology name	Description
1	**Quantitative metrics**	Quantitative indicators such as total waste or CO_2 emissions, including averages or figures adjusted for income.
2	**Qualitative or binary metrics**	Qualitative assessments based on MNE press releases or annual reports such as CO_2 reduction strategies. Can also contain binary values 1 (yes) and 0 (no).
3	**Assessment of key aspects**	Research by a third party or rating provider on key issues such as innovation, investment in renewable energy sources that are added to the main indicators or may change the weighting of the indicators.
4	**Other elements such as best-in-sector**	MNE industry leaders with the best ESG performance or the potential to improve their ESG performance. This can be in absolute terms or compared in an ESG segment.

While a variety of analytical approaches can contribute to pricing and efficient markets, the current state of such approaches and limited transparency further hinders comparison of E-score among major providers. As more investors turn to ESG ratings to help guide their climate goals in portfolio allocation, a more standardized or comparable approach across rating providers could help reallocate capital away from carbon-intensive economic activity. According to Riccardo Boffo [8], there are currently significant differences in the number and choice of quantitative dimensions of the "E" indicator, as well as in the methods of calculation and weighting of individual dimensions. These differences contribute to the wide variation in assessment scores between suppliers, as well as the lack of consistency between MNE harmful emissions and waste and their overall ESG scores. In addition, methodologies such as best-in-sector weighting are used to recalibrate certain MNE in high-emitting industries such as energy. This practice of assigning high and low scores to each industry to help reduce portfolio concentration may also result in some high-emitting MNE still having relatively high "E" scores.

Despite the above limitations, calculating MNE ESG rating and reporting on individual indicators can unlock a significant amount of information about MNE risk management and sustainability strategies, including climate risk management and transition strategies to achieve long-term business and enterprise value. It can also be an important market mechanism to help investors make decisions about long-term carbon pricing and climate change risks associated with climate change mitigation policies. For this purpose, it is necessary to continue to develop methodologies for assessing the level of the "E" indicator, so that they contain indicators that clearly distinguish between financial materiality factors and predictive indicators to support the

identification and management of climate risks and opportunities of MNE. The implementation of this initiative will increase the level of market integrity, investor confidence and market stability.

Figure 1 provides a conceptual framework for assessing the key factors that may influence market pricing associated with the transition to a low-carbon economy.

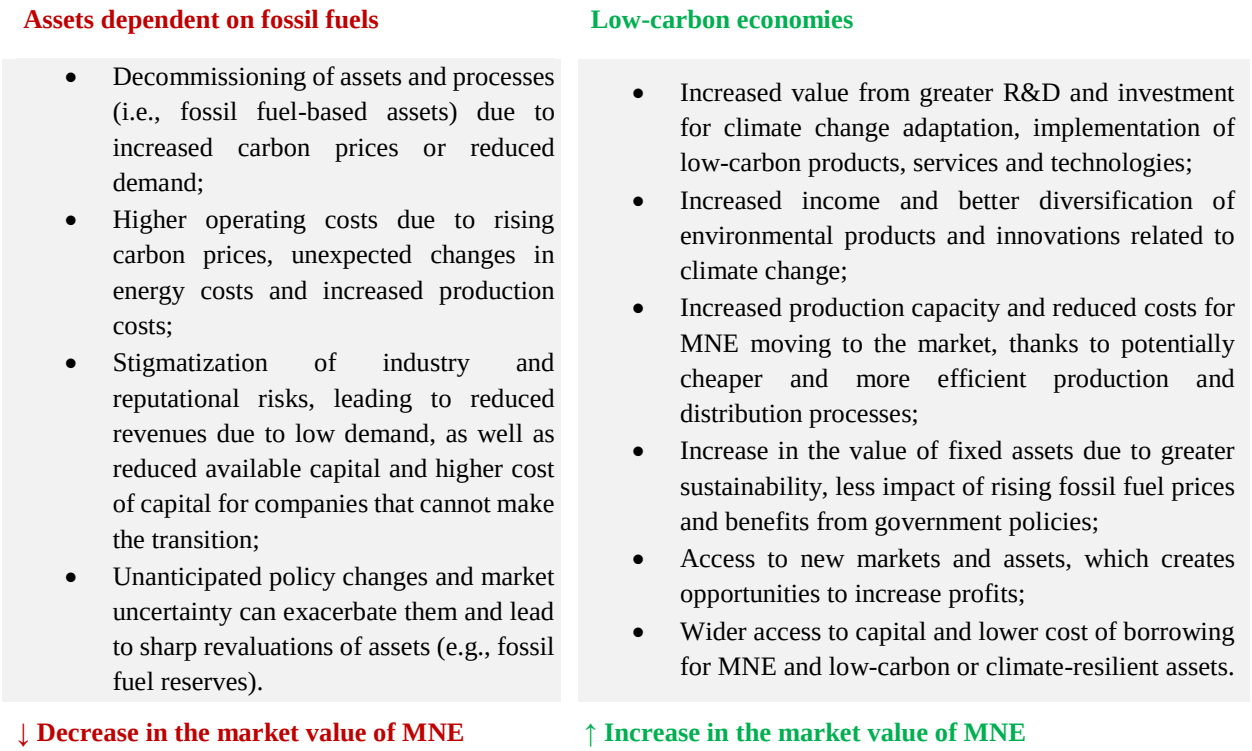

Figure 1. Conceptual basis of market pricing related to the transition to a low-carbon economy.

Pressure on the market value of MNE may arise from the increasing likelihood of fossil fuel reserve assets failing, as well as production processes becoming obsolete as the use of fossil fuels becomes prohibitively expensive. Increased capital expenditure to meet climate transition requirements and to reduce climate risks will lead to increased operating costs. Factors such as the accelerated decommissioning of machines and installations for the extraction and processing of carbon assets increase the costs of MNE. In addition, the cost of capital for carbon-intensive assets may increase both due to factors related to asset performance and anticipated changes in prudential and other investment regulation. The stigmatization of carbon-intensive sectors and reputational risks can affect sales, costs, and access to capital and the cost of capital for carbon-intensive MNE that are unable or unwilling to transition.

An increase in the market value of MNE can occur due to a number of factors that reflect expectations of increased future cash flows or a decrease in the cost of capital. This may include income from any assets that are in higher demand due to the demand and consumption of various renewable energy sources. In addition, cash flows could increase from increased production capacity and reduced operating costs for MNE in transition due to potentially cheaper and more efficient production and distribution processes (especially as renewable energy costs become cost-competitive with fossil fuels). In addition, access to new markets can create opportunities for new investment and increased profits through greater demand for low-emission infrastructure, technology and services.

As MNE increasingly face the pricing of the low-carbon transition, a number of instruments are emerging in capital markets to better support them under transition conditions. Figure 2 [9] shows a diagram of financial market products and instruments aimed at supporting the climate transition.

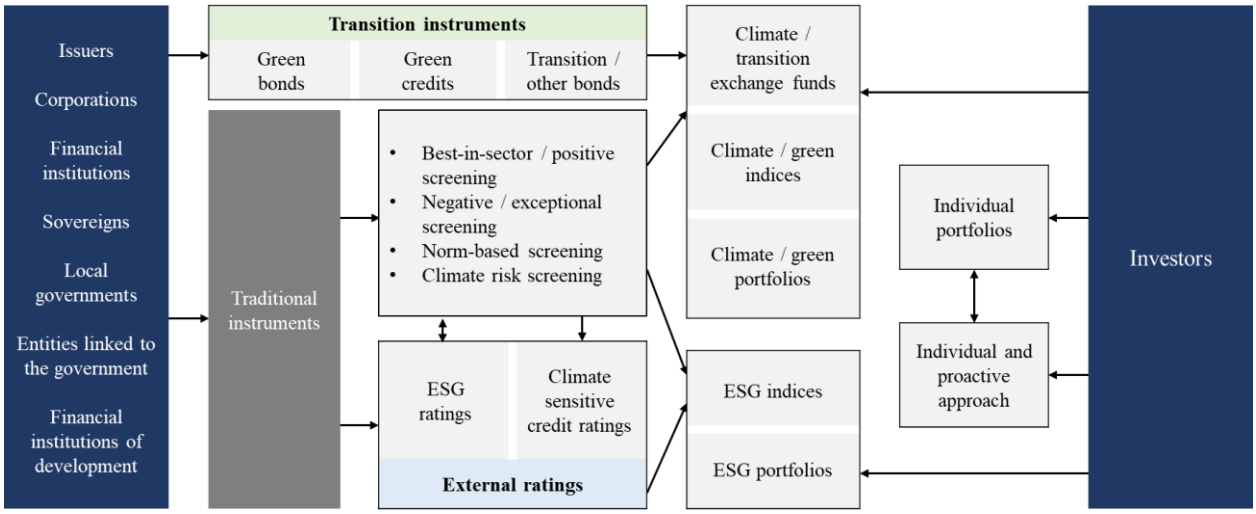

Figure 2. Conceptual basis of market pricing related to the transition to a low-carbon economy.

The products and instruments described in Figure 2 have evolved rapidly from relatively early stages of development, and additional policy levers may be needed to ensure the resilience and integrity of financial markets, to help strengthen their ability to facilitate an orderly climate transition. For example, climate transition benchmarks and investment funds, in addition to screening and governance strategies (including shareholder activism), demonstrate the potential to help directly support climate transition and in some cases may demonstrate the potential to deliver higher risk-adjusted returns. Climate scenario analysis and stress testing also demonstrate benefits in terms of identifying potential financial risks associated with climate change, but can also be used to help MNE identify opportunities (e.g., new technologies and innovations) in the context of transition. While the increased demand for products and tools that support the transition to a low-carbon economy is promising, more efforts are needed to improve the verifiability of background information and strategies related to MNE climate transitions.

5. ESG CONCEPT AS A DETERMINANT OF CORPORATE RISK MANAGEMENT STRATEGY

On April 30, 2019, following a formal request from the European Commission and a consultation process, the European Securities and Markets Authority (ESMA) published technical guidance on proposed amendments to the UCITS Directive and the AIFMD Directive with the aim of integrating sustainability risk factors [13]. The proposed changes concern:

1. Organizational requirements: general requirements for procedures and organization, resources and control on the part of senior management, the supervisory function and the governing body;
2. Operational requirements: due diligence and conflict of interest;
3. Risk management policies.

The Guidelines primarily emphasize the consideration of sustainable development risk categories in the MNE's risk appetite statement, which include environmental, social, or governance events that, when they occur, may cause an actual or potential significant negative impact on the value of the investment due to an adverse impact on the MNE's sustainability.

The proposed amendments set out in the Guidelines also affect a number of tools and methodologies that MNE use for risk management. They include:

- *Governance structures*: ensuring joint responsibility of senior management for the integration of sustainable development risks;
- *Risk owners*: ensuring that the MNE has the skills, knowledge and experience to manage sustainability risks with the recommended appointment of a qualified person to integrate sustainability risks into the overall risk management system of the MNE;
- *Principles of risk assessment and control*: MNE should be able to identify and assess sustainability risks and seek to mitigate them where possible. This includes active interaction with investee companies;
- *Reporting*: Sustainability risks are taken into account when creating, implementing and maintaining effective reporting within MNE and with third parties.

The definition of sustainability risk refers to environmental, social and governance events or conditions, but there is no regulatory definition for these events or conditions. However, the taxonomy and disclosure provisions refer to the following ESG criteria, actions and practices:

- *Environment*: climate change, sustainable use and protection of water and marine resources, transition to a circular economy, prevention and recycling of waste, pollution prevention control and protection of healthy ecosystems;

- *Social*: equality, social cohesion, social integration and labor relations;
- *Governance*: sound governance structures, employee relations, remuneration of relevant staff and tax compliance.

Sustainability risk may affect other areas of risk, including governance risk (e.g., whether the integration of sustainability risk has the necessary senior management oversight), operational risk (e.g., the impact of environmental events on operations), regulatory risk (e.g., compliance with amended UCITS directives and AIFMD), behavioral risk (e.g., distorting the carbon footprint of an investment product to attract more investment).

MNE should ensure that they have appropriate methodologies, tools, criteria and practices for sustainability risks, including policies, procedures (as proposed in the Guidelines), risk register, commitment register, reflecting changed legislation and commitments. All this should correspond to the risk appetite of MNE.

ESG incidents are becoming more and more important and expensive, which emphasizes the need to integrate the ESG concept into the risk management strategy of MNE. Studies have found that MNE that have experienced serious ESG incidents have lost an average of 6% of their market capitalization [14]. For example, in 2015 the pharmaceutical company Valeant, which was once the most valuable on the Toronto Stock Exchange, lost 90% of its market value due to accounting and pricing scandals [15]. On the other hand, MNE that implement effective ESG risk management practices are less likely to face these kinds of problems and losses.

6. CONCLUSIONS

Over the past few years, the world economy has developed a steady demand for stable financing, including an increase in the number of relevant financial instruments, the growing attention of a wide range of stakeholders (investors, politicians, international organizations such as the UN, civil society) to the activities of multinational enterprises (MNE) that generate financial returns in line with societal values and contribute to overall macroeconomic sustainability and the fight against climate change. With the growing corresponding demand, the concept of taking into account environmental, social and governance factors (ESG) began to form in the system of international economic relations, which replaced the concept of Corporate Social Responsibility (CSR). While ESG and CSR activities are corporate, CSR initiatives are voluntary for MNE, whereas ESG programs are usually implemented as part of a broader corporate strategy to meet investor or regulatory requirements.

A number of conducted studies indicate that the implementation of a number of ESG aspects positively affects the corporate financial indicators of MNE over time due to the improvement of the corporate governance and risk management system. Also, they help to reduce the impact of catastrophic risks on MNE, according to the assessment of "tail" risk of the normal distribution over a certain period of time.

Historical analysis has shown that ESG risks are becoming more important and expensive, which emphasizes the need to integrate the ESG concept into the risk management strategy of MNE. On the other hand, when analyzing the latest global economic trends, it is possible to clearly observe the correlation between the environmental component of the ESG concept and the global initiative to transition to a low-carbon economy. Already today, MNE that depend on fossil fuels for their operations are seeing their capitalization decline, as low-carbon MNE thus provide increased cash flows and lower cost of capital.

That is why the integration of the ESG concept into the corporate risk management strategies of MNE is an integral condition for improving their corporate governance systems, improving operational and financial efficiency, and acquiring resilience to systemic macroeconomic shocks.

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