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ESG Risk Management and Compliance Practices in China

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Abstract

In 2004, the United Nations released the "Who Cares Wins" report, in which the concept of Environment, Social Responsibility, Corporate Governance (ESG) was first introduced as an evaluation criterion and important reference for investment decisions and corporate the concept of ESG was first introduced in the report, and was used as an evaluation criterion and important reference for investment decisions, business operations and other activities. ESG, as a new concept to prevent social and environmental risks and promote sustainable development, is driving the continuous change of investment philosophy and investment approach in China's capital market, and has become an issue that cannot be ignored by enterprises. At the same time, ESG compliance has also become an important special compliance area, putting forward new requirements for corporate compliance management.

Keywords: ESG risk, risk management, ESG compliance management

1. Introduction

In early 2022, the World Economic Forum (WEF) released the Global Risk Report 2022, which investigates global risk trends in five areas: economic, environmental, social, technological and geopolitical. The 2022 Global Risks Report shows that more than half of the top 10 global risks in the next decade are ESG-related, including failure of climate action, extreme weather and biodiversity destruction (Table 1). For companies, global ESG risks are bound to have an impact on their business activities in the face of complex and changing external conditions. Companies urgently need to take action to handle the increasingly severe external situation.

Table 1. Identify the most severe risks on a global scale over the next 10 years

1st	Climate action failure	Environmental
2nd	Extreme weather	Environmental
3rd	Biodiversity loss	Environmental
4th	Social cohesion erosion	Societa
5th	Livelihood crises	Societa
6th	Infectious diseases	Societa

7th	Human environmental damage	Environmental
8th	Natural resource crises	Environmental
9th	Debt crises	Economic
10th	Geoeconomic confrontation	Geopolitical

Source: World Economic Forum Global Risks Perception Survey 2021-2022

2. The Necessity of ESG Risk Management for Enterprises

2.1 The Compliance Requirements of Laws and Policies are the Basis of ESG Risk Management

In recent years, with the progressive reform of China's capital market and the continuous improvement of supporting policy measures, more and more regulatory departments and industry self-regulatory organizations have included requirements for enterprises to fulfill social responsibility in relevant regulations and policies, involving topics such as labor safety, employee welfare, poverty alleviation and charity, as well as responding to stakeholders' interest concerns. In the ESG concept, the current legal and regulatory system constrains companies' performance at the environmental level and corporate governance level more strictly, and relates to penalties for non-compliance with environmental incidents and non-compliant corporate governance behaviors. At the level of social responsibility, the current legal policies mainly focus on whether enterprises take certain measures to protect the legitimate rights and interests of shareholders, creditors, employees, consumers and other stakeholders, while encouraging enterprises to encourage active support for poverty alleviation and charity work.

2.2 Supply Chain Development Exacerbates ESG Risk Transmission Within the Industry

Companies with higher ESG scores have better performance in corporate governance and sustainable development, and thus have higher-than-industry-average risk control capabilities in supply chain management, and the frequency of negative information such as deception and litigation, as well as stock trading fluctuations, is relatively lower, which does not have a greater impact on the company's share price and thus has a more stable effect on the company's value discovery. The ESG score effectively integrates the three elements of corporate governance: environment, social responsibility, and corporate governance. The ESG score effectively integrates three aspects of corporate information: environment, social responsibility and corporate governance, and better reflects the management and risk status of the company, thus forming a risk transmission mechanism that a high ESG score reflects strong corporate governance, low negative information and volatility, and high-risk control. Therefore, the emphasis on ESG will be more conducive to the stable development of enterprises in the supply chain and the sustainable development of the whole industry chain.

2.3 ESG Risk Management Effects Corporate Financial Performance

For enterprises, the non-financial information disclosure of listed companies can reveal the potential risks of enterprises, and such ESG risks may have a negative impact on the financial performance of enterprises in the short term, bringing direct economic losses, and in the long term, they will affect the reputation of enterprises in the market, brands and other intangible assets, thus further impacting the construction of enterprise value, and such losses are often huge, even leading to the bankruptcy of enterprises This loss is often huge and even the main factor leading to enterprise bankruptcy. Therefore, for companies to achieve their own sustainable development, they need to present their leadership in ESG risk management matters and reasonable and effective corporate governance mechanisms to their stakeholders, especially the financial markets, which are both necessary for sustainable growth and for investors to pay more and more attention to the ESG performance of their investment targets, and are the core elements of ESG risk management for companies.

3. ESG Risk Management Status of Chinese Listed Enterprises

This paper selects the ESG risk index of the Southern Weekend Good Choice Cloud ESG Risk Alert Platform as the sample data for analysis, because the platform monitors the risks in environmental, social and governance areas for nearly 6,000 Chinese companies listed on A-shares, U.S. stocks and Hong Kong stocks, and evaluates the ESG risk performance of listed companies, which forms the ESG risk index of listed companies. This paper uses the platform's monitoring data from March to August 2022 to analyze the ESG risk performance of Chinese listed companies.

3.1 The Overall ESG Risk Index of Listed Companies Shows a Decreasing Trend

According to the platform monitoring results, 283 ESG risk events occurred in A-share listed companies in

August 2022, and the cumulative value of ESG risk index was 722.5 (Figure 1). Compared with July, both the number of risk events and the risk index have decreased.

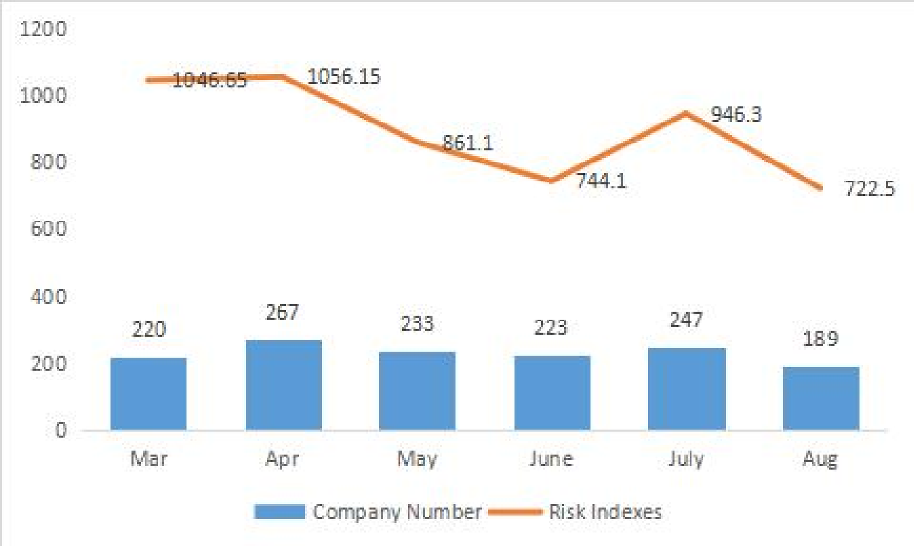

Figure 1. A-share listed companies' ESG risk index and number of companies, March-August 2022

3.2 Manufacturing, Finance, and Internet Technology Industries are the Three Industries with High ESG Risk

Among the 19 monitored industries, the number of ESG events and risk indices of three industries, manufacturing, finance, and Internet technology industry, consistently ranked in the top three from March to August (Figure 2). ESG risks in the manufacturing industry are manifested in information disclosure violations and product service quality and safety issues. The financial industry is characterized by violations of branch credit business and infringement of consumer rights, mainly in the form of indiscriminate fees, illegal collection and use of personal information. ESG risks in the Internet technology industry are mainly focused on data privacy and security, which is one of the most important factors for investors to make investment decisions. The real estate industry risks are mainly manifested in the business decline that continues to challenge the company's management ability, as well as the continuous exposure to product quality and project delivery delays. In addition, the overall ESG risk index of the financial industry, Internet technology industry and real estate industry is on a downward trend, except for the fluctuation of ESG risk in the manufacturing industry.

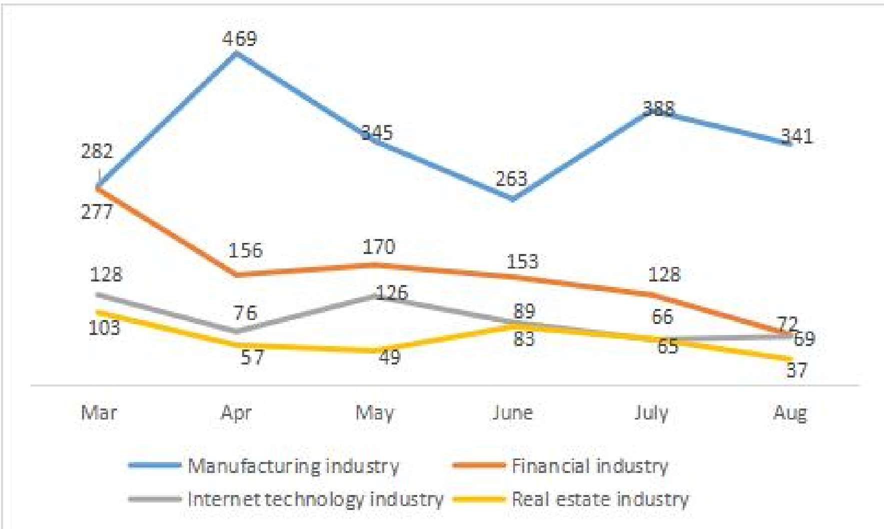

Figure 2. ESG risk trends in key industries, March-August

3.3 The Current ESG Development of Listed Companies Have a Significant Imbalance in the Three Dimensions of E, S, G

The platform monitoring data shows that the corporate governance and management behavior dimensions account for the highest proportion of ESG risk events, followed by exposure to social dimensions, with the lowest proportion of exposure to environmental dimensions (Figure 3). The most prominent issues exposed to governance risk are business continuity issues due to profit decline and mine explosion, as well as fraudulent or irregular information disclosure, and financial fraud and inflated profits. In contrast, from the ESG investment market, the capital market has the most pan-ESG products, such as green and low-carbon, due to the advantages of environmental dimensions that are fairly easy to quantify and offer industrial development opportunities. Management behavior and social factors are often underappreciated when evaluating the ESG investment value of companies, but they are also the dimensions of high ESG risk. From the perspective of sustainable development, both the capital market and listed companies need to pay attention to the social dimension as well as to improve their own management.

Figure 3. ESG risk index by dimension, March-August

4. Corporate ESG Compliance Points and Recommendations

So far, there are no specific requirements for ESG in the laws around the world, and ESG-related disclosure is left mainly to companies' discretion. With the rapid development of compliance around the world, regulators and regulators will impose increasingly stringent requirements on ESG. Therefore, companies should focus on ESG compliance, identify ESG compliance points, and prepare for internal changes as early as possible.

4.1 ESG Compliance Key Points for Enterprises

ESG compliance means that companies have to comply with relevant laws, best practices and expectations, where compliance with relevant laws means complying with mandatory requirements such as relevant laws and regulations; compliance with best practices and expectations means, in the absence of clear legal and regulatory requirements, voluntarily complying with more mature best practices at home and abroad to meet the increasing external expectations. Internationally, the 2019 EU Sustainable Financial Disclosure Regulation is legislation involving ESG, which is a mandatory requirement for enterprises and will expose them to ESG compliance risks if they do not comply, while the 2006 UN Principles for Responsible Investment, the 2016 UN 2030 Agenda for Sustainable Development and the rating indicator systems proposed by various international rating agencies are best practice practices. Companies can voluntarily choose whether to comply or not. Notably, the EU Sustainable Financial Disclosure Regulation provides two paths for companies to fulfill their ESG compliance obligations: first, to complete all SFDR reporting requirements; and second, companies with fewer than 500 employees can choose to explain the gaps between their ESG policies and SFDR requirements. This significantly reduces the risk of ESG non-compliance for companies.

4.2 Suggestions for Corporate ESG Compliance Practices

When strengthening ESG compliance management, we can refer to the relevant international standards issued by the International Organization for Standardization (ISO) first, especially ISO 31000 [Risk Management-Principles and guidelines], ISO 37301:2021 [Compliance Management Systems-Requirements with guidance for use]. Meanwhile, the domestic standards that SMEs can refer to are also the group standard [Evaluation of the effectiveness of compliance management system for SMEs], which puts forward targeted evaluation criteria for the compliance management system of SMEs. Specifically, the following are recommended.

4.2.1 Strengthen Top-Level Design, Focus on Non-Financial Information Disclosure, and Enhance Supervision

An appropriate corporate compliance management department or personnel should undertake ESG compliance work, formulate ESG compliance policies and management processes according to the timely and effective identification of ESG compliance obligations, control ESG compliance risks, and guarantee the achievement of ESG compliance objectives. Simultaneously, relevant business departments of the enterprise shall assist the compliance management department or personnel in carrying out ESG compliance work. The ESG-related compliance responsibilities of the corporate compliance management department or personnel mainly include collecting and identifying ESG compliance obligations, especially legal and regulatory requirements, and translating them into internal corporate rules and regulations; identifying, monitoring and disposing of ESG compliance risks; conducting ESG compliance training and promoting ESG compliance culture. The ESG-related compliance responsibilities of the relevant business units of the enterprise include timely reporting of ESG non-compliance and suspicious behavior; timely communication of the corporate ESG compliance policy and its changes to the department.

4.2.2 Strengthen Corporate Sustainability and Construct an ESG Risk Management Framework

Integrating ESG-related risks into governance structures, systems and processes is a key initiative for companies to improve their sustainability. ESG risk identification means identifying the mandatory and voluntary obligations related to an enterprise's business activities, products and services. ESG risk assessment means analyzing and grading ESG compliance risks based on the probability of occurrence and the extent of impact of ESG risks, and determining the level of ESG risks and ESG risk response is to control ESG compliance risks by adopting daily monitoring, reporting mechanism, and reporting mechanism, etc. ESG risk identification, assessment and response are ongoing and need to be carried out continuously according to the actual situation and needs.

4.2.3 Create a Corporate ESG Compliance Culture

Specific measures include commitment and support for ESG compliance by the principal and senior management of the enterprise; compliance commitment by relevant employees and performance assessment of their compliance duties; internal and external communication and conveyance of ESG compliance information, including the promotion, training and communication of ESG compliance knowledge and concepts, etc. Among them, corporate principals and senior management should take the lead from themselves to advocate ESG compliance values and concepts, build compliance culture from top to bottom, and carry ESG compliance throughout.

Against the backdrop of the spreading epidemic and intensifying climate change, ESG risks worldwide have brought significant challenges to enterprises. ESG is absolutely not a new cost or burden for compliance; precisely the opposite, ESG compliance is a scientifically based solution to establish an effective path for long-term corporate development and to address the core issues of sustainable corporate development such as more resource-saving, cost-saving and risk-reducing. Therefore, it is necessary for relevant companies to undertake initiatives to understand and study the concepts of ESG, ESG investment and ESG compliance, and to implement ESG compliance management. Achieving good ESG risk management and integrating it into the consideration of corporate strategy and goal setting may help companies better cope with the complex and changing external situation and become the key to achieve long-term sustainable development.

Declaration

The data in this article are from the ShanZeYun Platform (https://csr.infzm.com) of the CSR Research Center of China, Southern Weekend.

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