The Russian sanctions: A catalyst for ESG?

"To put it bluntly, will companies enact courageous ESG policies only when it does not hurt?...This is a moment of truth. Stakeholders have been increasingly mobilised to question the premises of companies' professed ESG activities. All too frequently, corporations and their executives engage in marketing or obfuscation of what they're actually doing — what could more accurately be called 'ESG-washing.' Will this prove to be another case of looking the other way?"[1]

These words from former Ukrainian finance minister Natalie Jaresko serve as a call to action for many organizations as they relate to sanctions and environmental, social and governance (ESG) policies. Jaresko's powerful and challenging sentiments may apply equally to governments around the world. Since the United Nations' COP26 climate summit in 2021, ESG has grown in prominence among policy makers, and financial institutions have committed to implementing ESG frameworks and making business decisions aligned with those commitments.

However, the war in Ukraine and the implementation of sanctions and embargoes on Russia and Belarus by many in the West and their allies have potentially significant impacts on the ESG agenda. While these events may at first seem to create challenges for ESG policies or reasons to delay or dilute commitments, responses by governments, regulators and financial institutions may help to shape a more robust and mature approach to ESG.

Implementing and maintaining meaningful ESG programs has never been short of challenges. Because of the range of topics included under the umbrella of ESG and the lack of a common framework for ESG programs, setting out the requirements and the expected outcomes has largely been determined on an institution-by-institution basis. Russian sanctions have introduced an additional complexity as policy makers and institutions consider how — or even whether — geopolitical considerations should alter the ESG agenda. Key challenges across the ESG dimensions posed by the sanctions and countries' responses to them include those described below.

1 "Russia's Invasion of Ukraine Must Prompt an ESG Reckoning," by Natalie Jaresko, *Financial Times*, March 3, 2022, www.ft.com/content/cfbb1598-5d69-4649-8c19-6c7c56e30664.

Environmental challenges

Russian sanctions may have differing short-term and long-term effects on environmental objectives:

- Sanctions restrict the supply of Russian oil, gas and other fossil fuel products, forcing dependent economies to search for alternative sources of energy. In the short term, many countries have turned to other fossil fuels or rolled back energy policies to compensate for supply shortages and spiraling energy costs and to ensure national energy security. For example, the U.S. has issued an emergency waiver permitting year-round sales of E15 gasoline, which contains a 15% ethanol blend, in a bid to lessen the impacts of Russian sanctions on gas prices.[2]
- Some financial commentators and analysts[3] assert that the Russian sanctions will strengthen political will and support and ultimately accelerate the transition to green energy. Investments in renewables and other green energy sources are gaining momentum, but some will question whether the political will exists to invest in renewables with high fuel prices still being a leading contributor to inflation. Governments will be faced with deciding whether, and how, they can simultaneously alleviate the cost of living and fund renewable-energy projects.
- Pivoting away from Russian fossil fuels and the resultant impact on energy prices may lead to greater consideration of nuclear energy. While it may be an alternative, nuclear energy is not universally viewed as green energy. That disconnect may impact ESG taxonomies.
- Russia is a significant source of certain "conflict minerals" such as nickel (a key input for electric car batteries) and other rare earth minerals. Their lack of availability and increased cost due to sanctions may further slow the development of renewable energy.

Societal challenges

The enormous human cost of the Ukraine conflict touches on the human rights standards often prioritized in ESG frameworks. The conflict has raised many questions about its impact on society, including:

- The ethics of continuing business with those not subject to sanctions in Russia and Belarus.
- The economic effect of the withdrawal of business, loss of jobs and inflation on the Russian and Belarusian people.

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2 "Biden Waiving Ethanol Rule in Bid to Lower Gasoline Prices," CNBC.com, April 12, 2022, www.cnbc.com/2022/04/12/biden-waiving-ethanol-rule-in-bid-to-lower-gasoline-prices.html.

3 "BlackRock's Fink Predicts Renewable 'Investment Boom' as Ukraine War Accelerates Energy Transition," by Harriet Agnew, *Financial Times*, April 13, 2022, www.ft.com/content/b4a4facf-3bf9-4b28-8264-d5231d4ea9db.

- Financing armaments,[4] particularly in instances related to Western governments providing arms to the Ukraine government. Although, prior to the conflict, many financial institutions shied away from engaging with clients involved in armament design and manufacturing, some of them may now reevaluate their position. Many ethical investors, however, will likely continue to avoid the arms sector.
- The risks arising from the refugee crisis, such as human trafficking and slavery.

Governance challenges

Senior managers are expected to lead the development of appropriate ESG frameworks and may focus on ethics and their organizations' long-term agendas at the expense of short-term profits. In response to the Russian sanctions, many organizations proactively announced the cessation of business with Russia or put investments outside of the sanctions remit on hold. Organizations that took longer to respond or have chosen to continue trading with Russia may not have fared well in the court of public opinion (including having been outed on websites that track the status of business relationships with Russia)[5] and will need to assess any reputational fallout.

Evolution and maturity of ESG

Organizations have been responding not only to the immediate challenges that the sanctions present but also to the broader impact across the organization and to their ESG agendas.

Thus far, governments and organizations have been focused on the E and to some degree the S — diversity, equity and inclusion (DEI) in particular — perhaps because those components have become more important to the public. The scope of the ESG dimensions is very broad and thus not consistently defined, resulting in disparate application of the principles across organizations. Consequently, there are bound to be trade-offs between them, as exemplified by corporate responses to the Russian sanctions, in order to achieve long-term goals.

Managing shifting priorities over time and responding to global macroeconomic and geopolitical events will be a key part of the ESG agenda. Organizations need to be agile and responsive to business, economic and societal changes and embrace short-term tactical challenges as the potential drivers of ESG framework evolution and maturity.

4 "What Impact Will the Russian Invasion of Ukraine Have on ESG Investing?" by Sofia Karadima, Investment Monitor, March 28, 2022, www.investmentmonitor.ai/special-focus/ukraine-crisis/russian-invasion-ukraine-esg-investing.

5 "Over 750 Companies Have Curtailed Operations in Russia — But Some Remain," Yale School of Management, April 26, 2022, www.som.yale.edu/story/2022/over-750-companies-have-curtailed-operations-russia-some-remain.

The Russian sanctions are highlighting risks that may have a place in an ethical ESG framework, including:

- Human rights
- Energy security and policy
- Geopolitical tensions, including military conflicts.

In the financial services industry, ESG is frequently implemented at a security, loan or industry level with little consideration for nation, country or region of origin. However, the Russian sanctions have brought country of origin to the fore as an additional risk factor of an ESG framework.

Additionally, certain controls within an ESG framework may be supplemented by leveraging actions that have been taken to manage the Russian sanctions. For example, organizations will assess third parties (e.g., suppliers, customers, counterparties and investees along with the wider group and related party structure) for alignment with their ESG criteria, and stakeholders may demand that future assessments become more sophisticated, accounting for sanctions, ethics, reputation and brand.

ESG standards, frameworks, data providers, benchmarks, ratings and rankings have yet to adapt to the challenges raised by the Russian sanctions. Across the ESG ecosystem, the sanctions will be a key factor in recalibrating ESG requirements for the new-world circumstances. Financial regulators will also be considering the impact in their guidance.

Questions for financial institutions

While some financial institutions have made progress integrating ESG frameworks into their operations, others have just begun the process. Either way, they may need to consider additional factors. Some questions that organizations should ask include:

- Has senior management been involved in discussions about the broader impacts of Russian sanctions on the business and the organization's risk decisions? Have ethical and wider reputational impacts been considered?
- What are stakeholder expectations and the firm's responses in situations of conflict?
- How has the firm's definition of *ESG* been impacted by the Russian sanctions? Are there grounds for building geopolitical and ancillary risks into the ESG framework?
- Which ESG consequences should be prioritized (e.g., human rights, climate and energy, global governance, society)? How might these priorities evolve over time, and what are the triggers for shifting from a tactical to a strategic approach to managing them?

- How could third-party risk be integrated into existing processes and procedures for ESG and sanctions risk assessments?
- How does an ESG ecosystem constituent's ethics and culture impact the definition of the S of *ESG*? What tools (e.g., metrics, ratings, benchmarks) can be used to measure and track its progress?
- Are other actions or policies necessary?

Conclusions

ESG frameworks are very broad and open to interpretation. Many organizations and, in some countries, regulators continue to determine what they should cover as they develop their priorities. Frameworks will evolve and mature only after they are challenged, but, as challenges emerge, recognizing that there will be trade-offs between ESG elements over time will allow for a more nuanced debate and accelerate the process.

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