# EXPLORING THE EMERGING IMPACT OF ESG FACTORS ON CORPORATIONS AND FINANCIAL INSTITUTIONS

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## INTRODUCTION

The term Environmental, Social and Governance ("**ESG**") is currently in the limelight of most if not all, symposiums in the corporate industry. Nevertheless, it was first introduced in the "Who Cares Wins" Report 2004 commissioned by the United Nations Global Compact with the ultimate goal to develop guidelines and recommendations on the means to better integrate environmental, social and corporate governance issues in asset management, securities brokerage services and associated research functions. Up until today, the term itself has been interpreted and used widely by different professionals, stakeholders, investors and corporations.

Essentially, each element of ESG may be briefly interpreted as follows:

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| Environmental | : | An organisation's impact on living and non-living natural systems, including land, air, water and ecosystems[1]; |
| Social | : | The impacts an organisation has on the social systems within which it operates[2]; and |
| Governance | : | The organisation's approach on its internal policies for good corporate governance and to meet the expectations of stakeholders. |

## EFFECTS AND INDICATIONS OF ESG CONSIDERATIONS IN THE FINANCING SECTOR

Bank Negara Malaysia ("**BNM**") recognised the utmost importance of ESG considerations in promoting the sustainability of a financial institution. As such, through the issuance of the BNM's Corporate Governance Policy, BNM had expressly enshrined the board's responsibility to consider ESG factors to promote sustainability in the policy[3].

Arguably, financial institutions are the ones who have spearheaded the incorporation of ESG considerations in their businesses. For instance, banks in Malaysia had begun to introduce the following measures such as introducing clauses in their documentations to ensure that the borrower complies with the ESG law i.e. all applicable laws, relating to ESG and express their commitments to phase out from financing new coal activities.

[1] Bursa Malaysia, *Sustainability Reporting Guide*, (3rd edition, 2022)
[2] Bursa Malaysia, *Sustainability Reporting Guide*, (3rd edition, 2022)
[3] Standard 8.3(e) of the BNM Corporate Governance Policy

As succinctly illustrated by the examples abovementioned, the contemporary trend is that financial institutions are reluctant to provide financial services to corporations which do not have proper ESG practices in place. Inevitably, this, in turn, would compel corporations to adopt ESG considerations in their businesses. Accordingly, the entire supply chain will be affected and will incorporate ESG considerations in its decision-making process.

## EFFECT OF ESG FACTORS ON MALAYSIAN COMPANIES

In addition to the above, the boards of Malaysian companies, particularly, listed companies, are urged to include ESG considerations in their decision-making processes due to the following factors, *inter alia*, the Listing Requirements of Bursa Malaysia ("**Bursa**"), the Malaysian Code on Corporate Governance ("**MCCG**") and the shifted expectations of the investors. Amongst others, signatories to the United Nations Principles of Responsible Investment have committed to shy away from companies that do not have a good ESG practice in place[4].

Private equity firms have also become progressively selective of their portfolio companies and have the tendency to turn down an investment opportunity due to ESG concerns[5]. Further, these firms are actively prompting their portfolio companies to incorporate ESG considerations in their business operations by offering a plethora of ESG resources to assist them to address their ESG concerns[6].

In addition, the shareholders who strongly promote sustainability practices would ensure the boards consider ESG factors whilst making their decisions. In fact, the dissatisfied shareholders are entitled to exercise their rights to vote against the re-election of the directors for their failure to consider the ESG factors. This is well-illustrated in January 2021 whereby BlackRock rejected the re-election of six independent directors of Top Glove Corporation Berhad ("**Top Glove**") for the board's failure in its oversight responsibility over the health and safety of its migrant workers living in its dormitories[7].

Accordingly, the boards are now obliged to integrate ESG factors whilst operating businesses to remain relevant and to compete with their competitors. In fact, the boards could seek professional opinions from ESG experts to enhance the corporation's ESG practice. To ensure that Malaysian companies particularly, the small and medium enterprises, remain relevant in this ESG trend, the Ministry of International Trade and Industry ("**MITI**") is targeted to launch an ESG framework as a guidance by the end of 2023[8].

It is trite to note that the incorporation of ESG factors should not be perceived as a compliance burden, but instead, as an opportunity for the corporation to enhance its sustainability practices. In fact, several multinational companies ("**MNCs**") have seized the opportunity and established ESG committees which bear the responsibility to outline the strategy, framework and processes for the integration of ESG factors in the MNCs in alignment with their objectives. Research has also shown that a strong ESG practice has a positive correlation with the corporation's growth; the uplift of employee productivity; as well as the optimisation of the corporation's assets and capital[9]. This is supported by the emerging trend for non-listed companies to adopt ESG practices on a voluntary basis.

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[4] Bursa Malaysia, *Sustainability Reporting Guide*, (3rd edition, 2022)
[5] PricewaterhouseCoopers, 'How Private Equity Funds Can Achieve Their ESG Goals' (June 2021) <https://www.pwc.com/us/en/industries/financial-services/library/achieving-esg-goals.html> accessed 11 May 2023
[6] Teck Wee Tiong, Fi Ling Quak and Radha Curpen, 'Mondaq Comparative Guide to ESG 2022 – Singapore Charter' (2022)
[7] Kathy Fong, 'BlackRock voted against re-election of Top Glove independent directors amid foreign worker issue' *The Edge* (Kuala Lumpur, 6 January 2021)
[8] 'Malaysia to launch ESG framework by year-end - Tengku Zafrul' *The Star* (Bangi, 11 April 2023)
[9] Witold Henisz, Tim Koller and Robin Nuttall, 'Five Ways that ESG Creates Value' (2019) McKinsey Quarterly <https://www.mckinsey.com/capabilities/strategy-and-corporate-finance/our-insights/five-ways-that-esg-creates-value#/> accessed 11 May 2023

**GREENWASHING**

Briefly, an act or process of creating false impression or misleading investors or consumers on the environmental practices of a company or its product and services would amount to “greenwashing”. Without a doubt, the reward for adopting a good ESG practice is promising. However, companies should, at all costs, avoid making an unsubstantiated climate-related statement without putting in the necessary efforts, which amounts to “greenwashing”. One of the recent interesting headlines was on Deutsche Bank’s DWS on allegations of “greenwashing” and misleading investments[10].

**COMMENTS**

Despite the profound impact of ESG factors on contemporary business operations, no legislation relating to ESG has yet been introduced in Malaysia. Therefore, the consequences for failure to consider ESG factors are primarily governed by the policies abovementioned and the ESG contractual clause (if any). For instance, a supply contract could be drafted to include an ESG clause which expressly stipulates the breach of such clause could give rise to a right for (i) liquidated ascertained damages or (ii) a suspension or termination (or a combination of both). In any event, it is indeed thrilling to witness how the much-anticipated MITI ESG framework would further integrate ESG factors in Malaysian corporations.

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*Disclaimer: The contents do not constitute legal advice, are not intended to be a substitute for legal advice and should not be relied upon as such.*

[10] Tom Sims and Marta Orosz, ‘Deutsche Bank’s DWS sued by consumer group over alleged greenwashing’ *Reuters* (24 October 2022)