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ANALYTICAL COMMENTARY

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SUSTAINABLE DEVELOPMENT | RUSSIA

GLOBAL SHIFT IN THE ESG AGENDA: HOW INTERNATIONAL AND RUSSIAN APPROACHES TO ACCOUNTING ESG RISKS ARE CHANGING

Accounting ESG risks in the current geopolitical conditions

The Russian ESG agenda is not in crisis, instead, a reassessment of approaches to this topic as a whole is taking place against the backdrop of general geopolitical turbulence.

In 2021, not long before the geopolitical situation began to change, the wave of ESG investing and ESG assessments reached the Russian financial market. In Europe, America and Asia the boom in assigning ESG assessments and issuing instruments tied to sustainability goals has been going on for at least five or six years now.

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The number of companies assessed by major providers of ESG data and ratings has grown from year to year. By March 2022, the databases of the two largest providers of ESG ratings (Sustainalytics and MSCI), respectively, contained 14,000 and 11,500 companies whose financial instruments were being traded in developed capital markets. The number of alternative providers of ESG assessments, ratings, scoring products, as well as advisors for liaising with ESG agencies has also grown rapidly. According to Morningstar, assets worth around USD 2.7 tln are currently managed by more than 2,900 so-called ESG funds. In Q4 2021 alone, the sector received around USD 142.5 bln. Basically, a new global financial and consulting industry of assessments, verifications and various databases in the field of ESG has emerged.

However, the **approaches, methodology and transparency of providers of ESG assessments, as well as the concept of ESG investing itself, became a controversial topic among certain representatives of the academic and professional community** long before the geopolitical environment began to change. The abundance, and, most importantly, low mutual correlation of ESG ratings enabled companies to select assessments that made them look more attractive in the eyes of investors and consumers, and, vice versa, to hide low ratings.

Before the geopolitical landscape started changing, a number of national financial regulators and supranational organizations advocated the development of common approaches to regulating the field of ESG assessments, rankings and ratings.

The array of problems related to the low level of transparency and correlation of ESG assessments negatively affected confidence in ESG stock and bond funds, as well as the motivation of companies themselves to work on improving their objective ESG metrics, such as pollution or injury rates.

Before the geopolitical landscape started changing, a number of national financial regulators and supranational organizations (such as the IOSCO) advocated the development of common approaches to regulating the sphere of ESG assessments, rankings and ratings. It got to the point that the regulatory authorities of the United

States and Germany launched an official investigation into greenwashing at asset manager DWS (part of the Deutsche Bank group).

ACRA believes that current events will somewhat slow down the process of introducing regulation of ESG finances in Western capital markets, but will not bring it to a standstill. The EU has already rolled out a number of mandatory documents, primarily the Sustainable Finance Disclosure Regulation (SFDR), EU Green Taxonomy, and European Green Bond Standard (EUGBS), that contain a set of requirements for financial market participants, including those related to the use of external ESG assessments, as well as requirements for the disclosure of information about the structure of funds that call themselves 'ESG-oriented'.

Similar processes can be seen in the American market. In 2022, the Securities and Exchange Commission published draft regulation, according to which ESG-focused investment advisors and funds will be required to provide investors with verified and comparable data on the ESG metrics targeted by funds. In theory, this should lower the share of greenwashing in the US financial market and is in essence an analog of the EU's SFDR.

The downgrade or withdrawal of ESG ratings of Russia-based companies by foreign providers (even if such companies were not affiliated with the state) has raised additional questions about their methods and procedures. Prior to the start of 2022, Russian securities issuers were generally improving their standing in international ratings and rankings. Furthermore, systems for assessing the efficiency of individual corporate divisions and management started taking performance in ratings into account. The widespread decline of ratings wiped out many years of work.

Foreign investors, the previous drivers of the Russian ESG agenda, will be absent for a long time.

Amid the current situation, the professional community is actively discussing the need for ESG assessments in Russia. It is clear that the **previous driving factors — foreign investors — will be absent for a long time.**

Over the past three months, the professional community has started moving toward a certain consensus regarding possible drivers that are capable of somehow maintaining the ESG agenda.

In ACRA's opinion, the need for ESG assessments linked to the prospects of companies entering the financial markets of Asia and the Middle East, about which a lot has been said recently (since the requirements of these stock exchanges are sometimes even tougher than European exchanges), is overestimated. Firstly, these markets are tightly integrated into the international agenda, and therefore working with companies from Russia entails the risk of sanctions. Secondly, Asian exchanges — especially those in China — have their own set of consultants, verifiers, and agencies from whom ESG assessments need to be received in order to obtain financing via these markets.

However, according to ACRA, Russian companies will continue to need ESG assessments, rankings and scoring products for a number of reasons. Firstly, **some companies view the ESG agenda as an integral part of their corporate culture, and do not plan to get rid of it.** These companies need a set of metrics, rankings and ratings that allow them to continue to compare themselves to global and national industry leaders. Many foreign providers have stopped offering this expertise to Russian companies, so a temporary switch to Russian providers is possible in order to ensure the continuity of practices and procedures.

The same is true for issuers of green, social and sustainability bonds. Companies that looked at possible issuance of such instruments before the change in the geopolitical situation are not abandoning their plans and, as the key rate decreases, will enter the market with these financial instruments. If the Bank of Russia continues the cycle of key rate cuts until the end of the year and issuers have the opportunity to issue bonds, ACRA expects at least seven issuers of ESG bonds (including green, adaptation and sustainable development bonds) worth at least RUB 6 bln to enter the market in 2022.

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Second, **large businesses still need to assess their supply chains** in terms of both financial reliability and ESG risks.

Third, external assessments from independent national providers may be of interest to a number of government-owned and quasi-state organizations (for example, VEB.RF, which intends to maintain its focus on green finance).

Fourth, **by the end of 2021, national ESG regulatory framework was created in Russia**. In the fall of 2021, a national taxonomy of green projects was introduced, which includes a section of adaptation projects specific to the Russian economy. The first version of a social taxonomy has been developed, reference books on the best available technologies (one of the pillars for the green finance criterion) have been developed and are planned to be updated. A number of documents, albeit advisory in nature, have been issued by the Bank of Russia, including recommendations on the disclosure of climate-related information to financial market participants.

Although most of these documents are advisory and are not associated with any specific incentives or, on the contrary, administrative pressure, they form the foundation for national sustainable finance standards. In addition, national green construction standards for residential and commercial projects are currently being developed, which will replace the BREEAM and LEED standards that have left the Russian market.

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What role does the ESG agenda play in the post-crisis recovery of the Russian economy and the period of structural transformation? Despite a number of calls for softer environmental requirements for new and existing businesses, in the medium and long term, ESG issues will not be struck off the agenda. In particular, if the state supports infrastructure projects as part of stimulation measures, then their implementation is expedient only taking into account key social and environmental factors. In this regard, it would be unreasonable to reject such a tool as **IRIIS, which has been created and tested by VEB.RF over the past two years**. ACRA took an active part in piloting this tool and was the only verifier who participated in the assessment of all three components of the methodology: Economy and Governance, Quality of Life, and Environment and Climate.

A potential growth point for the ESG agenda is the **introduction of environmental and social responsibility assessments in public procurement**, in line with the best international practices. In the EU, green procurement is embedded in the overall procurement system, policies and work of public authorities, reflected in legislation and national action plans, and the environmental procurement criteria themselves have been approved for 21 groups of products and services. In the US, the Environmental Protection Agency's Environmentally Preferable Purchasing Program helps purchasers meet environmental requirements and thereby stimulates the market for green products. The legislation of Japan, China and Taiwan gives preference to groups of goods that have a national environmental certificate (eco-label).

It is highly likely that regulations similar to CBAM may appear in China and other countries to which Russian companies are now trying to redirect export flows.

So far, **Russia's current obligations under the Paris Climate Agreement have not been removed from the agenda**. Although there are some calls for Russia to withdraw from this agreement, the climate agenda will remain relevant for Russian companies for a number of internal and external reasons. First of all, not all Russian exports are subject to embargoes and sanctions, including nickel, aluminum, and a number of other metals. Consequently, the relevance of the EU Carbon Border Adjustment Mechanism (CBAM), which is planned to be introduced in 2026 for a number of products, in particular, aluminum, remains relevant. In addition, **it is highly likely that regulations similar to CBAM may appear in China and other countries to which Russian companies are now trying to redirect export flows**.

The internal drivers of the climate agenda are that Russia is experiencing a more serious impact of climate change than many developed economies. **The country is located in latitudes where climate warming is two-and-a-half times faster than the global average**, and in Russia's Arctic zone, where part of the infrastructure of large companies is located, this process is four to six times faster. Warming observed in the permafrost regions is one of the main threats to the infrastructure of the largest Russian corporations, as it may significantly affect their financial performance in the future. In addition, **economic damage from forest fires in Russia, according to preliminary estimates of the Ministry of Natural Resources, amounted to RUB 10.6 bln in 2021**. This figure will increase if urgent measures are not taken.

Finally, Russia and Russian businesses will **eventually return to the global economy that will highly likely be different by that time**. In April 2022, the European Commission published a plan to eliminate Europe's dependence on Russian energy resources (REPowerEU) by 2027. The plan covers three main areas: saving energy, diversifying the supply of fossil fuels, and accelerating the transition to cleaner fuels.

The EU's energy transition will gain momentum, despite a short-term increase in the share of coal in the EU's energy mix in 2021–2022.

For these purposes, according to the EC's estimates, additional investments of EUR 210 bln by 2027 and EUR 300 bln by 2030 are needed. These amounts are required in addition to those already allocated for the EU 2030 Climate Target Plan (reducing greenhouse gas emissions by at least 55% below 1990 levels). Consequently, the so-called **energy transition will gain momentum, despite a short-term increase in the share of coal in the EU's energy mix in 2021–2022**.

In addition, according to the International Renewable Energy Agency's estimates, in the period from 2010 to 2019, the cost of a kilowatt-hour produced using renewable energy sources decreased from 82% for solar PV systems to 29% for offshore wind farms. This was mainly driven by declining costs of technologies and consumables. According to ACRA's estimates, if oil and gas prices remain high for a long time, **the share of renewable electricity in the EU may grow faster than under the previous geopolitical conditions**.

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