From compliance to commitment: ESG and the future of insurance

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First coined in the mid '80s, the term "greenwashing" has achieved widespread attention in recent times, as a number of organisations have made (unwanted) headlines, being held to account for misrepresentation of environmental performance, disclosures and reporting and ESG more broadly. Extending beyond greenwashing, ESG refers to a far broader set of metrics, including human rights and diversity and inclusion.

The absence of a mandatory global sustainability reporting framework has resulted in environmental and sustainability reporting practices lacking transparency and reliability. Despite a recent crack down on greenwashing from Australia's competition watchdog, the Australian Competition and Consumer Commission (ACCC) and the Australian Securities and Investments Commission (ASIC) disclosure guidelines, Australia, in many respects, has not yet seen the level of ESG claims activity that has been seen in America and Europe.

Broad-based ESG reporting remains voluntary in Australia for now, aside from certain mandatory reporting obligations under discrete pieces of legislation (for example the *Modern Slavery Act 2018 (Cth)* and the *National Greenhouse and Energy Reporting Act 2007*, however it is only a matter of time until there are more consistent, transparent and reliable reporting requirements.

Impacting the organisation, regulators, consumers and investors, the investment community in particular has made clear that ESG accountability will continue to be a key driver in where funds are invested going forward. The drive to obtain a competitive advantage, paired with renewed attention from Australia's regulators, means that new legislative frameworks and an era of structured sustainability reporting are an inevitability in the Australian market. Similarly, it seems inevitable that there will be a corresponding increase in ESG claims in the Australian market over the coming years, as reporting expectations are clarified and failure to comply with those expectations come under sharp focus.

This report outlines the current state of play of ESG in Australia, and how this space is likely to develop in the near future.

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What is ESG?

ESG stands for Environmental, Social and Governance, a broad framework that is used to measure a company's behaviour and impact on society and the environment. Delivering these metrics to socially conscious investors is increasingly important in allowing a large section of the market to determine potential appropriate investments, locate growth opportunities, material risks and determines whether a company holds long-term stakeholder value.

Environmental standards include factors such as energy use, waste, and corporate climate policies. As the world becomes increasingly environmentally aware, there has never been more importance placed on companies evaluating any environmental risks they might face and how the company will manage those risks.

Relevant environmental considerations include: Direct and indirect greenhouse gas emissions, management of toxic waste, and compliance with environmental regulations.

Social standards include factors such as the company's relationships with its internal and external stakeholders. The promotion of ethical and socially conscious themes is expected to reflect in customer satisfaction and employee engagement.

Relevant social considerations include: Community engagement, including a focus on First Nations peoples, ethical supply chain and sourcing and health and safety.

Governance standards covers factors such as whether a company uses accurate and transparent accounting methods, integrity and diversity in its leadership and accountability to shareholders. Again, investors are likely to look more favourably on companies displaying a commitment to avoiding conflicts of interest, illegal conduct and ensuring diversity and inclusion throughout its organisation.

Relevant social considerations include: ESG and other reporting, disclosures, board diversity, and tax transparency.

Why is ESG significant?

Investors and stakeholders have recognised the importance of responsible corporate behaviour and its impact on a company's ultimate long-term sustainability and performance to internal and external stakeholders. In applying a sophisticated ESG framework, individuals or other corporations can determine whether a particular company aligns with their values and assess the merits of investing in that company.

ESG initiatives are directly aligned with the following business factors relevant to the long-term success of the organisation:

- **Corporate reputation** – ESG can enhance a company's license to operate making it easier to accomplish business objectives and respond to crisis scenarios with key stakeholder groups.
- **Risk reduction** – ESG can assist with the identification of immediate and long-term risks depending on the industry and business model.
- **Opportunity management** – shifting market and non-market conditions can expose unmet needs for new products and/or services, potential customer bases and potential strategic relationships for addressing ESG issues.
- **Culture & Intrinsic values** – ESG maturity is an indicator of a company's commitment to building a high performing, purpose-driven workforce, and inclusive culture.

As a result, many investors are now incorporating ESG considerations into their investment decisions.

Global trends

The global ESG trend has continued to grow rapidly in recent years. According to a report by Bloomberg Intelligence, global ESG funds and assets may surpass $50 trillion by 2025, an upward trend from $35 trillion in 2020 – leading to the presumption that ESG trend assets will grow at 15% which is a third of the pace of the past five years.[1]

The COVID-19 pandemic also accelerated the general trend towards a focus on ESG, due to a combination of factors with an emphasis on internal workforce expectations, the importance of ESG in the war for talent and increased scrutiny on corporate performance which forced companies to adapt to changing consumer and stakeholder demands.

According to an analysis by MSCI, of more than 30 emerging risks set to impact corporations and investors worldwide in 2023 and beyond, the key themes of the predicted ESG and climate investing trends include:

- **Innovations in the supply chain**, including prospects of tracking goods through blockchain technology and the mining of e-waste that could reshape the dynamics of controversial raw material sourcing;
- **Changing governance**, with exploration of how new corporate board demographics could play a role in say-on-climate and other proxy voting trends;
- **Responses to regulation**, including tangible impacts of new rules on asset managers, institutional investors, and corporations;
- **Work life changes**, such as the proliferation of railroad strikes and labour rights movements globally;
- **New frontiers in measurement and transparency**, with insurers and banks set to expand scope of emissions tracking;
- **Emergence of new investments**, ranging from lab-grown commodities to carbon as an asset class;
- **Turning points for ESG assets**, including green bonds and nuclear energy.[2]

ESG Claims

As ESG has moved towards centre stage, there has been a corresponding increase in ESG-related claims.

By way of a brief global snapshot, the following represent part of the first wave of global ESG claims against directors and officers and shareholder class actions.

ClientEarth v Shell's Board of Directors (UK)

On February 9, 2023, Shell shareholder ClientEarth filed a derivative action against Shell's Board of Directors alleging mismanaging of material and foreseeable climate risk and breaching company law. ClientEarth alleges Shell's 11 directors breached their legal duties by failing to adopt and implement an energy transition strategy that aligns with the Paris Agreement.

This case is significant as it is the first example in England and Wales of an activist shareholder applying established principles of company law to an ESG claim. Currently, we are awaiting an indication from the court as to whether it will grant permission for the claim to proceed. If this claim proceeds, we anticipate that it will encourage similar actions to be commenced.

Re McDonald's Corporation Stockholder Derivative Litigation (USA)

Stockholders of McDonald's filed a derivative action against the Company's board of directors, former CEO, and former Global Chief People Officer. They alleged that from 2015 until 2020, the Company's directors breached their duty of oversight by ignoring red flags about a corporate culture that condoned sexual harassment and misconduct and also their fiduciary duties in relation to the hiring of the former CEO.

This case serves as reminder of the potential ramifications for failing to implement systems to monitor and appropriately address the social and governance aspects of ESG and the potentially critical impact on a company of failing to do so.

Re Pfizer Inc. Shareholder Derivative Litigation (USA)

On November 18, 2009, Louisiana Sheriff's Pension and Relief and Skandia Life Insurance Company, Ltd. and fellow shareholders, filed a derivative action against Pfizer for the illegal marketing of at least 13 of the Company's most important regulated drugs.

As part of an ultimate settlement for in excess of $1 billion, Pfizer agreed to enter into an expansive corporate integrity agreement with the Office of Inspector General of the Department of Health and Human Services. The proceedings stand as a stark reminder of the implications of perceived failures in governance and the imposition of corporate governance and integrity policies in response to sch claims.

Australasian Centre for Corporate Responsibility (ACCR) v Santos (AUS)

The ACCR launched legal proceedings in the Federal Court alleging that Santos Ltd has breached the Corporations Act 2001 (Cth) and the Australian Consumer Law by engaging in misleading or deceptive conduct relating to its claims that it provides clean energy natural gas and has a plan for net zero emissions by 2040.

This "greenwashing" case shows the potential exposure which companies may face if they fail to accurately record information about their response to net zero emissions targets and representations as to their green credentials, against a background where investors' ability to assess the sustainability of their investment is an increasingly important factor.

In late 2022, the ACCR further expanded its allegations (following disclosure of additional documents) to include a raft of further specific alleged ESG failures. To quote Brynn O'Brien, Executive Director of ACCR,

"The litigation discovery process has revealed further instances where we contend that Santos has engaged in greenwashing... We allege that Santos misled investors and the public about its plan to achieve 'net zero' by 2040 and to produce "zero-emissions" blue hydrogen. The documents produced by Santos have heightened our concerns that these plans lacked sufficient detail to be put into the market...

Investors rely on company disclosures and have a right to complete, open and honest information relating to a company they are investing, or considering investing, in."[3]

The Regulators - Developments in Australia

Although the Australian ESG reporting regime is currently one of largely voluntary self-reporting, the winds are changing and there has been a significant amount of regulatory attention over the past 6 months in representations being made by a raft of Australian companies.

In our view, attention from the regulators represents the first phase for ESG claims in the Australian market and we anticipate considerably increased action in this space in the coming one to two years. Once a body of case law develops in the face of regulatory proceedings, and the legislative framework around reporting requirements take shape, we anticipate the second phase will begin to unfold, being proceedings against directors and officers and potential shareholder actions against listed Australian companies.

ACCC

At the end of 2022 and into the start of 2023, the ACCC conducted a high level investigation into 247 companies in an "internet sweep" to assess their green representations. The ACCC concluded that more than half of the companies reviewed had made concerning (potentially misleading) claims about their environmental practices. The cosmetic, clothing and footwear, food and drink sectors were found to have the highest proportion of concerning claims among the industries targeted in the investigation.

ACCC Deputy Chair Catriona Lowe concluded that *"Our sweep indicates a significant proportion of businesses are making vague or unclear environmental claims. This warrants further scrutiny".*[4]

In a publication from the ACCC on greenwashing, ACCC Deputy Chair Catriona Lowe emphasised that, *"the ACCC will conduct a range of education activities like businesses, including updating economy-wide guidance material, in addition to targeted guidance for specific sectors".*[5]

Referring to the internet sweep that the ACCC conducted on companies making green representations, Ms Lowe adds that "the sweep has helped inform our forthcoming guidance about what steps businesses need to take to improve the integrity of their environmental claims" and they "will engage directly with businesses and industry associations to improve compliance with the Australian Consumer Law."

The ACCC's focus remains on environmental compliance and encouraging businesses to cooperate when there are concerns of false or misleading marketing claims.

Annually, the ACCC announces a list of Compliance and Enforcement priorities. Outlined in these priorities are the areas of focus for the ACCC's compliance and enforcement activities for the following year.

We anticipate that the ACCC will continue to prioritise consumer and fair-trading issues in relation to environmental and sustainability claims in the coming year.

The ACCC's enforcement powers and remedies are far reaching and include:

- monetary penalties of up to $1.1 million for companies and up to $220 000 for individuals;
- injunctions;
- adverse publicity orders;
- corrective advertising orders;
- community service orders;
- disqualification orders; and
- ancillary orders.

ASIC

In line with one of ASIC's 2023 Enforcement Priorities referring to action against greenwashing, ASIC has issued over $150,000 in infringement notices in response to concerns about alleged 'greenwashing', which the regulator defines as *"the practice of misrepresenting the extent to which a financial product or investment strategy is environmentally friendly, sustainable or ethical"*[6].

ASIC recently released an information sheet to help companies avoid 'greenwashing' when marketing sustainability-related products, ASIC Commissioner Sean Hughes emphasising that, *"This is and will remain a priority area of focus. ASIC is continuing to monitor the market and will be looking for misleading claims about ESG and sustainability."*[7]

ASIC Deputy Chair Sarah Court said, *"We take our role to protect consumers and investors seriously and won't hesitate to take action to protect consumers where we identify poor conduct."*[8] Additionally, Ms Court emphasised that *"there is increased demand for sustainability-related financial products, and with that comes the growing risk of misleading marketing and greenwashing"*.[9]

ASIC has certainly made it clear that companies engaging in 'greenwashing' for the purpose of appearing favourable to internal and external stakeholders can expect to garner the attention of ASIC going forward. It is also important to note that, as well as companies being held liable for greenwashing, directors can be held personally liable. ASIC been clear that ensuring companies avoid engaging in greenwashing is part of the overall suite of director's duties.

In terms of the existing legislative framework, on which ASIC is currently relying, the Corporations Act 2001 (Corporations Act) and the *Australian Securities and Investments Commission Act 2001* (ASIC Act) contain general prohibitions against persons:

- engaging in dishonest, misleading or deceptive conduct; or
- making statements that are false or misleading in relation to a financial product or financial service[10].

ASIC have also made it clear that *"Particular risks of breaching the misleading statement prohibitions arise in relation to representations made about future matters that are not supported with reasonable grounds. For example, if you stated that you will achieve a certain carbon emissions target (such as net zero carbon emissions) by a particular date, this may amount to a representation about a future matter. Such a representation may be deemed to be misleading if you do not have reasonable grounds for making the representation"*.[11]

In addition, section 1013D(1)(l) of the Corporations Act provides that where a financial product has an investment component, its issuer must include in the PDS the extent to which labour standards or environmental, social or ethical considerations are taken into account in selecting, retaining or realising an investment.

Australian Securities and Investments Commission (ASIC) v Mercer Superannuation (Australia)

In reliance of the existing legislative framework, ASIC has commenced proceedings in the Federal Court against superannuation provider Mercer Superanunation. In addition to being the first "greenwashing" case prosecuted by ASIC, this represents the first time the regulator has used its powers against a superannuation trustee following the reforms introduced by the *Financial Sector Reform (Hayne Royal Commission Response) Act 2020 (Cth)*.

It is alleged that Mercer, which oversees $27.5 billion in assets, made false and misleading statements to their customers (and the public) about their sustainable investment options. Mercer allegedly marketed options for people deeply committed to sustainability and represented that the fund did not include investments in companies involved in carbon intensive fossil fuels, thermal coal, alcohol production and gambling.

In fact, ASIC alleges the Sustainable Plus fund operated by Mercer included investments in 49 companies involved in:

- the extraction or sale of fossil fuels;
- the production of alcohol; and
- the gambling industry.

ASIC is seeking declaratory and injunctive relief as well as pecuniary penalties from the Federal Court – including seeking injunctions which would prevent Mercer from continuing to make allegedly misleading statements on its website and order that Mercer ultimately publish details of any contraventions found by the Court.

While it remains to be seen how these proceedings evolve, ASIC's penalty powers alone are substantial (having been bolstered in the post Hayne environment). Under the new penalty provisions, the maximum civil penalty for individuals is the greater of 5,000 penalty units (currently $1.11 million) or three times the benefit obtained.

The maximum civil penalty for companies is the greater of:

- 50,000 penalty units (currently $11.1 million)
- three times the benefit obtained; or
- 10% of annual turnover, capped at 2.5 million penalty units (currently $555 million).

Legislative Changes on the Horizon

Whilst there has been a significantly increased focus on the part of Australia's leading companies on environmental, social and governance (ESG) reporting, broad-based ESG reporting remains largely voluntary. There are certain entities that have mandatory reporting obligations under various ESG-related acts such as greenhouse gases and anti-slavery legislation. However, some stakeholders have demanded far more comprehensive reporting requirements that cover a broader range of ESG issues.

The International Sustainability Standards Board published two Draft Exposure IFRS Sustainability Disclosure Standards in March 2022 which will form a comprehensive global baseline of disclosure (particularly designed to meet the information needs of investors). These standards are due to be finalised in the coming weeks and are likely to inform the regulatory and legislative frameworks ultimately implemented in Australia.

In January 2023, the Australian Government released a paper on the development of a climate risk disclosure framework for companies and financial institutions as well as plans to introduce mandatory sustainability and ESG reporting requirements for large Australian entities in the next few years.

In 2023-2024, it is likely that we will see legislation rolled out in relation to the environmental aspect of the ESG framework to combat greenwashing. In an interview with Pro Bono Australia, Stephen Jones, Federal Minister for Financial Services, said that in 2023, he would be investigating whether ESG definitions need to be legislated and that they are *"looking specifically at funds, at the 'E' part of the ESG"*.[12]

Furthermore, in a joint media release with The Hon Chris Bowen MP, Minister for Climate Change and Energy and Stephen Jones, they spoke of developing a comprehensive strategy involving the development of *"new standards or taxonomies for sustainable investment, further initiatives to reduce greenwashing and strengthen ESG labelling and more ambitious participation in global forums to support climate and sustainable finance frameworks and investment."*[13]

It appears certain that legislation will begin to develop over the coming 12-24 months, informed no doubt by decisions which begin to be handed down by the Courts in response to the first phase of regulator-led proceedings.

Implications for Insurers

For insurers, it is clear that ESG claims will continue to develop, mature and increase in volume. We anticipate that inside of the next 12 to 24 months, they will begin to transition from novelty to become a permanent part of the Australian claims landscape.

While the landscape is evolving, insurers can currently take away the following certainties:

- Phase One of the ESG claims landscape will continue to revolve around regulator-driven proceedings, civil penalties, injunctions and declaratory proceedings;
- Informed by Phase One, the legislative and regulatory framework will continue to crystalise over the course of the next 24 months;
- Phase Two of the ESG claims landscape is likely to see an increase in D&O claims, shareholder class actions and proceedings for damages generally, relating primarily to capital raising and ASX disclosures;
- As a general observation, we would also expect ESG claims to progress past the "low hanging fruit" of environmental/greenwashing claims, and for an increased focus on the 'S' and the 'G' – the references to gambling and alcohol companies in the Mercer proceedings perhaps the first sign that this is on the horizon.

Understanding, identifying and managing risk lies at the very heart of the insurance industry. The proliferation of ESG considerations presents a number of challenges to the industry, both from an underwriting and claims perspective.

As the area continues to develop in prominence and maturity in the Australian market, insurers (and their insureds) will need to carefully consider whether a raft of insurance products are adequately suited to meet this emerging claims area.

At the same time, there are also significant opportunities presented to insurers by developing ESG space.

Taking into account the ESG profile of a risk is a relatively new phenomenon and something which sophisticated insurers will continue rely on in undertaking risk analysis, particularly in the D&O market but also beyond.

From a risk perspective, a company and board which takes its ESG obligations seriously and implements considered and detailed policies in the space is likely to represent a far more appealing risk generally to an insurer. A concerted effort to ensure that a company is operating to the highest ESG standards is, by its very nature, likely to lower the risk profile of that company. For example, a high Workforce Health & Safety score for a company, reflecting its commitment to the "social" element of ESG, is likely to have a quantifiable and positive effect on employee accident and fatality levels – this can then be factored into the pricing.

Insurers who are able to understand and utilise company metrics across the entire range of ESG areas will be uniquely positioned to gain an unprecedented level of insight into their potential insureds, analyse risk and craft insurance products accordingly. As ESG-driven claims numbers increase, utilising ESG data to inform the selection and pricing of risk and the scope of cover provided will become vital to insurers.

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