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HOW THE NEW GEOPOLITICAL REALITY AFFECTS ESG

The war in Ukraine has enormous implications for sustainability goals, writes Marcus Pratsch, head of sustainable bonds and finance, DZ BANK AG.

THE war in Ukraine has a massive impact on all four dimensions of sustainability: economic, environmental, social and governance. It has already cost the lives of thousands of civilians and displaced millions of people from their homes. Health, education and housing systems are facing a new test of endurance. Rising commodity prices and trade disruptions are exacerbating inflationary pressures. Higher food prices could push millions of people, especially in the poorest and most vulnerable countries, further into poverty.

Given the 'weaponisation of gas', the war is also a wake-up call to expedite the global transition to a more secure and cleaner energy future. It makes clear that a successful development agenda requires inclusive partnerships at global, regional, national and local levels.

The past has taught us that negative external shocks widen the sustainability financing gap, making it even more important to mobilise private capital and allocate it through the capital market to sustainable projects with positive impact. Even before the Russian invasion, the world was not on track to achieve most of the United Nations' sustainable development goals. Unfortunately, many targets will be set back by the new geopolitical situation, so even more capital will be required in the future.

The war is increasingly becoming a test for the socially responsible investment movement. It will inevitably lead to a reassessment of ESG investment approaches and sustainable portfolios as it not only reveals Europe's high energy dependence on Russia and how vulnerable the global food system is, but also raises the question of geopolitical sustainability. Therefore, it is not surprising that the first sustainability rating agencies have revised their ESG risk assessment methodologies and added new geopolitical criteria.

The conflict has also renewed the question of how sustainable and safe invested capital is in countries with autocratic governments. In principle, an investment in government bonds and an investment in a company based or conducting business with authoritarian countries should be considered separately. But the boundaries are often not clear.

Corporates operating in authoritarian states are typically more exposed to sustainability risks than others operating only in democracies. Examples include human rights, corruption and reputational risks. Irrespective of a moral evaluation, such ESG risks have a negative impact on a company's performance. Hence, there is a question of how to treat companies that resume trading with Russia as concern becomes a source of systemic risk. The last few weeks have shown that more and more SRI investors are now excluding Russian companies as well as issuers with significant ties to Russia.

There is no question that the disruption of global energy markets has caused SRI investors to rethink energy strategies. Does the pace of fossil fuel phase-out need to be adjusted until renewables, hydrogen and storage technologies can fill the gap reliably and affordably? Will nuclear energy and natural gas gain importance as bridging technologies? Without a doubt, this new thinking should focus on renewable energy sources, energy infrastructure and sustainable technologies to support the transition away from traditional energy sources.

Finally, the war in Ukraine has also brought a controversial ESG discussion back onto the front pages. How should the issue of security and defence be interpreted in a sustainability context? Is defence ESG-compliant? Is 'Security the mother of all sustainability' as the Federation of the German Security and Defence Industries argues? How should SDG 16 (peace, justice and strong institutions) be interpreted in this context? A large pension fund has already surprisingly changed its investment policy to include even certain defence companies in selected ESG funds.

Although the conflict has revealed some flaws in ESG investing and shifted priorities, it is too early to say if it will lead to a total rethinking of ESG in the long term. But one thing is certain: mitigating and combating the economic, environmental and social consequences of such negative external shocks requires the help of the capital markets – and this must be done in a sustainable manner. •

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