The Importance of ESG in Brazil and the Future Role of Compliance

A cultural transformation has unquestionably occurred in recent decades, which has led to more environmental and social awareness among a new generation of consumers. This shift has had a profound impact on the financial world and on business practices. Apart from improving efficiency and risk management, companies have responded to this change by no longer solely focusing on profit, price and quality, but by incorporating ESG-related criteria and targets in their business activities. These criteria, which often go beyond any requirements set by law, stand for: **E**nvironmental, **S**ocial and Corporate **G**overnance.

The importance and urgency of ESG-related criteria for Brazil are self-evident. For example, a study from Rainforest Foundation Norway revealed that there is a link between the business activities of European car manufactures and the deforestation in the Amazon rainforest through the purchase of leather from cattle raised in illegally deforested areas. However, the pressure is not coming only from NGOs: big retail companies are pushing the European Commission to impose regulation against products that are linked with deforestation and supermarkets are considering boycotting Brazilian beef.

Unfortunately, deforestation is by no means the only problem in Brazil. Forced labour is still a major issue, which in recent years has worsened in sectors such as agriculture, the fashion industry and construction. In addition, areas of concerns include racism, gender inequality (Brazil has one of the worst gender gap index ratings in Latin America), hatred against minorities and LGBTQIA2+.

As a response, both European companies and Brazilian suppliers will have to adjust their internal processes by developing and implementing systems for compliance in ESG. In an attempt to contextualise and identify the breadth of such response, this briefing will list, non-exhaustively, some of the most relevant topics in each of the three ESG areas:

The **E**nvironmental criteria focus on the impact (positive or negative) of economic activities on the environment. Some of the aspects to be considered under this category include:

- climate change / global warming;
- sustainable chain of production (fair trade, local production, organic, etc.);
- carbon footprint / CO_2 emissions and other greenhouse gases;
- air pollution;
- green building;
- waste management;
- water management;
- renewable energy;
- natural resources.

The **S**ocial criteria are concerned with the company's relationship with society, both in terms of the relationship between the company and consumer/clients, as well as with its own employees. The following topics fall under this category:

- human rights;
- consumer law / product quality and safety;
- data protection;
- labour rights / workplace safety and security;
- minority rights / diversity / racial, gender, LGBTQI+ issues;
- supply chain management;
- child labour;

- forced labour;
- integration within the local community.

The **G**overnance criteria are concerned with the decision-making processes within businesses and the protection of different stakeholders' rights and interests. These criteria focus in particular on the structures, mechanisms and processes that align a company's business operations with ethical considerations aimed at bringing about the equal distribution of rights and responsibilities among the stakeholders. There also is a focus on:

- efficient and transparent accounting and fiscal processes;
- executive compensation and board composition;
- code of conduct and corporate values / management and accountability processes;
- integrity programmes / prevention of acts of corruption, fraud, collusion or coercive practices;
- prevention of anti-competitive practices.

It is worth emphasising that the move towards a more ESG-oriented market means that companies cannot restrict themselves to a strategy solely aimed at mitigating risks or damage. Investors and consumers expect a proactive attitude from companies to contribute to ESG-related goals.

ESG and Financial Markets

The ESG criteria have generated enormous traction in financial markets, which over the past years have increasingly incorporated these criteria. Far from being a marginal phenomenon, the figures of so-called ESG assets are impressive. According to a survey published by Bloomberg Intelligence in February 2021, by the end of 2021 the total volume of ESG assets will be **US$ 37.8 trillion**. Bloomberg also projected that by 2025 ESG assets will have a total value of **US$ 53 trillion** (more than a third of the total value of assets under management).

However, given the lack of regulation and the constantly evolving nature of ESG practices, questions around the actual risks, activities and structures are relevant to investors, remain open. To illustrate, in December 2020 the European Commission published a preliminary study (prepared by BlackRock Financial Markets Advisory) in which 42 banks (29 European and 13 non-European) were interviewed about the criteria they use in identifying ESG assets.[1] The findings are summarised below:

Macro-themes	Ranking	Illustrative themes	Details on key themes
Climate Change (E)	1	Physical weather events (81%)	**Physical Weather Events**: Climate change-driven weather conditions of acute (e.g., firestorms) and chronic (e.g., temperature rise) nature
		Transition to low-carbon economy (81%)	**Transition to Low-Carbon Economy**: Process of adjustment to a low-carbon economy (driven by policy, technology, consumer sentiment and other)

[1] Ranking: degree of importance given to the topic by the interviewees. Percentage of specific topic: percentage of respondents that apply the specific topic mentioned to their analysis.

		Carbon footprint (81%)	**Carbon Emissions / Footprint**: Impact of business activity on environment in terms of carbon emissions and environmental footprint Other themes: energy efficiency
Corporate Behaviour (G)	2	Business ethics (85%) Ownership control (73%) Audit, tax and risk management (65%)	**Business Ethics**: Promotion of a culture for sustainable business practices and the prevention of misconduct **Ownership & Control**: Guarantee alignment of interests through low concentration of power and understanding of anti-takeover devices **Audit & Tax**: Adherence to best practices and monitoring mechanisms to lower the frequency & scale of scandals, fraud, tax evasion, etc. Other themes: corruption, bribery, extortion and money laundering, tax evasion, fraud, anti-competitive practices
External Stakeholder Management (S)	3	Community relations / human rights (81%) Customer relations (65%)	**Community Relations**: Operating as a good corporate citizen that protects human rights, is accountable to local community, and offers access to basic needs **Customer Relations:** Focusing on customer welfare and satisfaction, through product quality, data privacy, and fair disclosure/marketing Other themes: public housing, discrimination, child labour, defence and weapons, cybersecurity
Natural Resources & Pollution (E)	4	Waste management (88%) Water management (85%)	**Waste Management / Toxic Emissions**: Management of waste and mitigation of toxic emissions generated by activity **Water Management / Stress**: Management of scare resources such as water

		Biodiversity & land use (73%)	**Biodiversity & Land Use**: Utilisation of natural land and protection of eco-system biodiversity
		Raw material sourcing (54%)	**Raw Material Sourcing**: Sustainable supply chain and procurement practices. Other themes: deforestation, nuclear weapons, air pollution
Board Quality (G)	5	Board independence (65%)	**Board Independence**: Alignment of interest of management and shareholders for objective decision-making and less possibility for entrenchment
		Board effectiveness (65%)	**Board effectiveness**: Structures and diverse backgrounds of members leading to better decision-making
Internal Stakeholder Management (S)	6	Workers' rights (77%)	**Worker's rights**: Ensuring employees' basic rights through positive labour relations, safe working conditions, and fair wages
		Diversity (69%)	**Diversity and Culture**: Creating a work environment that promotes employee satisfaction/morale, inclusion and diversity
		Talent management (50%)	**Talent Management**: Offering career development and skills trainings for employees, and managing hiring and retention
			Other themes: Health & safety, culture, racial equality

Regulatory developments

In relation to compliance in ESG, the EU has recently adopted two regulations. The first, which came into force in March 2021, is the Sustainable Finance Disclosure Regulation (SDFR) EU/2019/2088, which contains rules on sustainability-related disclosures in the financial services sector. The second regulation, coming into effect by the end of 2021, is the Taxonomy Regulation EU 2020/852, which establishes a framework for the promotion of sustainable investment.

In June 2021, Germany adopted the Supply Chain Act (*Lieferkettengesetz*), which establishes rules on the direct responsibility of German companies for social and environmental issues in their supply chain.

In Brazil, the Central Bank has recently launched a public consultation (n. 85/2021) on a draft resolution amending CMN Resolution n. 4,557/201 on the structure for risk management and capital management. The draft resolution aims to add requirements for financial institutions regarding the management of social, environmental and climate risks.

Despite these regulatory developments, however, the definition of ESG factors remains in a state of flux and evolves through a dynamic dialogue between regulators and market actors. At the same time, there is widely shared consensus for the need of effective compliance with ESG-related requirements.

Compliance with ESG-related criteria

Compliance is part of the **G**overnance category. However, its importance is not limited to this category, because compliance has a structural impact on the way in which companies will seek to define, monitor and accomplish their ESG goals. This means that business professionals seeking to improve compliance structures will not only need to help companies with identifying the applicable legal framework, but will actively have to contribute to the development, application and monitoring of an ESG programme.

Compliance is the tool by which companies can compare their present situation with the future objectives they set for themselves, can observe the way in which these objectives fit their business culture and economic activity and – most importantly – can define the procedures by which these objectives can be achieved in an ESG compliant manner.

Through due diligence procedures and internal controls, companies are able to collect and certify the accuracy of the information they are obliged to submit to financial market authorities as part of disclosure requirements, supervise the implementation of their guidelines and manage potential ESG-related risks.

Due to the dynamic and breadth of ESG criteria, which are not only defined by laws and regulations, but also by market-participants themselves, it is essential to have an ESG compliance structure that allows for regular evaluation of defined parameters in order to keep in line with the expectations of both the financial markets as well as consumers.

In other words, both European and Brazilian companies have to keep up in order not to be left behind. Brazilian companies will have to develop robust ESG compliance programmes to overcome the issues they and their country currently face and to show both investors and business clients that their business activities align with ESG-related expectations. At the same time, European companies will have to understand the specificities and characteristics of specific regions to avoid any unexpected risks. Therefore, it is necessary to develop mechanisms for identifying and monitoring potential exposures to ESG issues in Latin America, particularly in Brazil.

Both sides will also have to look into the future by proactively setting ESG objectives in order to access the huge volume of financial resources geared towards ESG-related investments and to maintain a competitive position in an increasingly demanding consumer market.