Managing the ethical risks of investing in emerging economies

Emerging markets can be a sustainable source of wealth or a significant risk to your entire business, writes **Paul Wenman** of InvestAssure.

Although labour is cheap in emerging economies and consumer markets are growing, environmental and other ethical practices leave much to be desired. When things go wrong this can result in potentially serious reputational, commercial, legal and financial impacts on businesses.

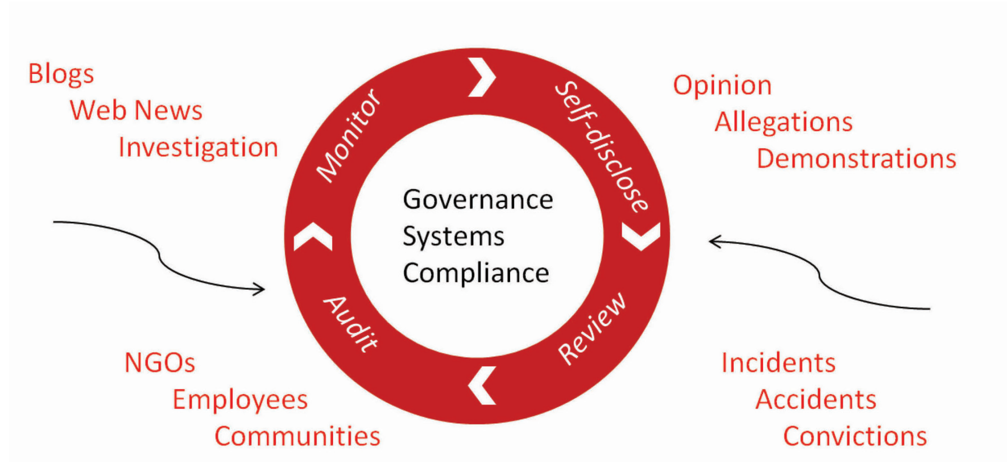
With the spread of the Internet, the media and other stakeholders are raising the profile of unethical business practices worldwide. Recent high-profile incidents have related to working practices (Foxconn), environmental pollution (Jinko Solar, Ramu Nickel mine), rainforest destruction (APP, Sinar Mas), corruption and fraud (Olympus), human rights and community impacts (Vedanta), food safety (Sanlu milk products) and occupational health and safety (Garib & Garib).

Thousands of such incidents occur annually which could surface to impact investments or supply chain integrity. A fundamental question for investors is 'where do the risks lie?', which companies, sectors and countries? And which ethical issues can be monitored and managed more easily?

NGOs and the media are major factors. Pressure groups target high profile projects, for example in the mining, hydro-electric, palm oil and paper industries, highlighting human rights abuses, deforestation and environmental impacts. But does NGO and media coverage present a balanced view? What is the real picture of performance across Asian companies? How should investors assess and monitor the risks?

Most investors now use corporate 'ESG' ratings for screening and risk analysis. These rely on self-disclosure on Environmental, Social and Governance issues – based on corporate reports and responses to questionnaires and self-assessments. But ESG ratings do not adequately incorporate data on accidents, incidents, poor performance, allegations or convictions.

Now, for the first time, a more quantified picture is becoming available by using the World Wide Web for monitoring corporate ESG performance. InvestAssure constantly monitors the internet for convictions, accidents, incidents and allegations of corporate malpractice. They use this information to raise monthly 'risk alerts' for pension funds, private equity and institutional investors, enabling early action to mitigate business damage and forming part of an ongoing business continuity management processes. But the cumulative trends now emerging are also very interesting.



A two-year analysis of the InvestAssure database reveals a picture which should be of concern for anyone with business interests in Asia:

- 20% of the 4,000 companies monitored had at least one significant incident or allegation
- 2/3 of 'alerts' warranted engagement or another proactive response
- 50% related to manufacturing (14% chemicals, 10% IT, 7% metals)
- 25% related to mining (2/3 metals, 1/3 coal)
- 30% related to occupational health and safety, 25% to environment
- 20% related to corruption, fraud or business ethics
- Over 50% were in China or involved Chinese companies overseas

InvestAssure estimates over 30% of major business operations in Asia fail to meet international standards and expectations for environmental performance and ethical practices.

Interestingly, India and labour conditions both figured lower than expected in the analysis. This may reflect the significantly higher overseas investment in and sourcing from Chinese manufacturers with poor records in environmental and health and safety performance. It may also reflect the difficulty of monitoring labour abuses in lower-tech sectors where India concentrates.

Their survey also showed a high correlation between companies in the news for ESG allegations and those that have published corporate reports on ESG. This suggests self-disclosure is not necessarily a reliable basis for evaluating corporate responsibility. In many cases a corporate ESG report is likely to have been published as a response to heavy NGO pressure and media attention on poor performance – rather than reflecting proactive and effective corporate governance.

It is clear from the InvestAssure data many aspects of EGS risks in Asia are overlooked by NGOs and the international media and self-disclosure can't be relied upon as a solid foundation for assessing and managing investment risks.

It seems a major weakness in the traditional approach to ESG risk management is the reliance on corporate self-disclosure. Disregard for real measures of corporate performance means that 'responsible investments' may not be meeting publicised standards and fund managers may be unaware of the real risks to their investments and businesses.

InvestAssure advocates integrated asset risk management which combines traditional screening and auditing with consideration of ESG performance data from web monitoring.

This can provide a more balanced, real-life view of asset ESG performance and enables managers to control real ESG risks proactively from the earliest stage, paving the way for enhanced governance and more effective management throughout the investment lifecycle. Resources can then be focused more effectively on damage prevention and creation of sustainable value. ■

InvestAssure (www.investassure.net) was founded by Paul Wenman of SourceAsia, Oxford (www.source-asia.net). James Pearson, of Pacific Risk Advisors (www.pacificriskadvisors.com) is the business development partner in Hong Kong.