AT THE HEART OF THINGS
THE GROWING SOCIAL ELEMENT OF ESG

As some countries slowly start to emerge from lockdown, what impact might this have on business practices and the role they have to play in protecting wider society?

From a financial services perspective, it is now more important than ever to view this emerging 'new normal' and possible future, both collectively and individually, through the lenses of environmental, social and governance (ESG) factors.

In the context of investing, ESG is a broad – typically numbers-based approach – which seeks to score a wide range of information about a firm or investment, from its impact on carbon emissions, to safety at work, and gender mix and wider diversity in the boardroom and beyond.

Environmental issues have been a priority for some time, reflecting growing concerns about climate change. New thinking is now emerging around the focus and application of ESG following the pandemic. While the emphasis has historically been on governance in the U.S., as opposed to environment in Europe and Asia, a shift has begun more broadly, with social concerns taking on more prominence, alongside environmental considerations.

What are social concerns?

According to the United Nations Sustainable Development Goals (UN SDG's), social elements consist of human rights, modern slavery, child labour, working conditions and employee relations. In terms of the real economy[1], the 'S' of ESG is cultural, more qualitative, and positive impact is difficult to measure.

As we move forward, efforts are likely to be more focused toward social issues than they have been, both in the short-term in relation to the COVID-19 relief that companies are providing for communities, consumers, their employees and other stakeholders, and over the longer term, where investors

may also ask questions about companies' processes and oversight, as well as how the board is engaged on these topics.

So companies, both big and small, are faced with a range of unprecedented challenges that require an even stronger focus on their corporate responsibility to their stakeholders, including their staff and wider community. Attention will be on those showing leadership in protecting their employees, their suppliers and business partners, customers and the communities they serve. Conversely, those who fail to do so will not go unnoticed.

The role of institutional investors in relation to social impact

The financial system plays a critical role in enabling economic recovery, its development and contributing to wider societal well-being. But as we look to the new normal, its role is developing further. Indeed, projecting into the future, the responsibilities of institutional investors may need to be reemphasised to respect human rights more broadly to ensure that the financial sector plays a more active role, contributing to more inclusive societies.

We can look to the developing position of the UN Principles of Responsible Investment (UN PRI)[2] to see how this may evolve. In 2020, the UN intends to publish details and guidance on how it expects signatories to meet this responsibility, including reporting[3], which includes:

- Short-term responses, and ensuring responsible ESG approaches remain at the forefront of investor activities; and
- A future economic recovery phase, considering how the financial system should function to ensure sustainable outcomes.

The UN is already thinking beyond the immediate health crisis as, in the aftermath, there will be a long journey to economic recovery. Therefore, now is a good time for individuals and investors to think about those systems and behaviours[4].

UN PRI immediate investor actions[5]

Regulations and other Principles

In addition to the UN PRI, there is guidance contained in the FSB Task Force on Climate-related Financial Disclosures (TCFD)[6] and the UK Stewardship Code.

In terms of European legislation, the EU Sustainable Action Plan and Green Deal, along with proposed changes to the Non-Financial Reporting Directive (NFRD) and the Shareholder Rights Directive II (SRD II) all have ESG requirements included.

SRD II in particular has the objective of increasing long-term focus in corporate governance and to address perceived shortcomings related to:

- Short-termism in the investment universe;
- Insufficient oversight on directors' pay;
- Insufficient oversight of related party transactions; and
- The interaction between companies and shareholders being ineffective in cross-border situations.

Making an impact

Impact investing has also gained further ground in the pandemic. Projects to upgrade outdated infrastructure, while also achieving environmental gains are emerging as top investments for funds that have built strategies on the UN SDGs. As well as infrastructure, other sector examples that are doing well include education, food security and sewerage[7].

Recently, several impact investing networks have formed a coalition to facilitate COVID-19 related impact investments called the Response, Recovery and Resilience Investment Coalition. This will be managed by the Global Impact Investing Network (GIIN) as the organising body. The coalition's goal is to streamline impact investing efforts that address the social and economic consequences of the COVID-19 pandemic through opportunities such as health interventions and access to capital. It will also target financing gaps and coordinate efforts to direct new capital to high-impact solutions, and share lessons learned with the wider investment community.

Can good culture help?

Ever since the financial crisis of 2007-2008, where poor culture and conduct were identified as one of the primary drivers of that crisis[8], regulators at both national and supranational levels have been examining the role culture plays in financial services. The lessons learnt have universal application.

While the nature and speed of regulatory approaches have differed between jurisdictions, one trend that has continued to gain increasing traction is the rise of personal accountability regimes. But how does this help the social elements of ESG? In places, an argument can be made that it has already begun to.

How? By following the cultural journey that firms have been making. As they recognise that openly shared values contribute to cultural norms within an organisation, it is equally understood that this tells only half the story. A healthy culture also ensures that people are thinking and doing the right thing when no one is looking. This stems from establishing a mind-set that knows right from wrong.

So what does right look like? No one size fits all, but positive indicators include:

- Conduct sponsored by and visible to the CEO.
- Programme design led by senior executives.
- Front-, middle-, and back-office coverage.
- Clear short-term and long-term goals.
- Conduct/culture linked to performance/pay.

A number of other areas of engagement and good practice also provide a supportive view. They touch on both quantitative and qualitative measures. These include:

Behavioural science
Understanding how people make decisions, not how they think they do.

Diversity and inclusion
Overcoming groupthink by embracing all its forms – gender, ethnicity, beliefs, education and experience.

Psychological safety
Freedom to speak up when there is a shared belief that the team is safe for interpersonal risk taking.

Transparency
How firms can deliver their vision and strategy such as gender pay gap reporting.

Good stewardship
Encouraging long-term shareholder engagement – SRD II and FRC's UK Stewardship Code 2020.

Effective boardroom challenge
The need for independent directors to provide effective oversight and scrutiny on fund boards.

Treating the vulnerable fairly
The requirement to demonstrate the fair treatment of vulnerable customers.

Non-financial misconduct
How seriously is it being handled? Bullying. Sexual misconduct. Discrimination. Favouritism. Intimidation. Exclusion.

As wider recognition and integration of these practices develops, then the more tangible the benefits should be. As firms apply a keener concern not only to the impacts to the environment of companies they invest in, but also to the social aspects that entails, such as human rights, modern slavery, child labour, working conditions and employee relations, then the greater the societal impact that can be expected.

Ongoing and longer term policy focus around ESG

As the EU looks at how best to recover from the impact of the COVID-19 pandemic, MEPs have said that the Green Deal in particular must be at the centre of any reconstruction package. Alongside this are the European Climate Law and the Climate Pact.

European Climate Law

This law sets in legislation the EU Objective to become climate neutral by 2050. It also aims to enhance efforts on adaptation to climate change. It looks to increase the EU's 2030 target from a 40% drop in GHG emissions, on the route to net zero by 2050, and while the level of the new target is not agreed, it is likely to be in the region of 50-55%[9].

Climate Pact

This looks for the involvement and commitment of stakeholders and the public at large. One of the areas that the Climate Pact looks to address is in individual and collective behaviours.

The European Commission has launched an open public consultation on the Climate Pact to give citizens and stakeholders a role in designing new climate actions, sharing information, launching grass roots activities and showcasing solutions that others can follow.

Inputs from this public consultation will be instrumental in shaping the Climate Pact before its launch later in 2020, as 'E', 'S' and 'G' take equal priority.

S – No longer a silent partner

In light of intense media and public focus on how companies are treating their workforces in the COVID-19 pandemic, policy makers may broaden disclosure requirements to encompass social issues too. In a news article, Kimberley Lewis, Director of Engagement at Federated Hermes, was quoted as saying that a company's actions in a crisis are the epitome of determining what its business purpose is[10].

Many have faced unprecedented changes to their daily lives to help contain the spread of the virus. Individuals have volunteered to help in whatever way they can, be it shopping for an elderly neighbour, stitching face masks for the front line, or raising money to give to those in need. The expectations from wider society on companies are converging: behave fairly and be aware of the social impact of the decisions they make.

The bigger picture

COVID-19 and climate change can be described as a joint emergency. Ultimately, the commitment of governments to policies tackling climate change will depend on the duration of the COVID-19 pandemic and the depth of the financial recession it causes.

While a severe COVID-19 downturn and even depression may delay climate action, the inescapable requirement to halt the warming of the planet and the need to attract private finance to do so is not going to change, and therefore neither will this fundamental policy goal.

The pandemic has also shown, in demonstrative ways, that there are real environmental benefits to be gained for societies from a less carbon intensive way of living. As industries, transport networks and businesses have temporarily closed down; they have brought a sudden drop in carbon emissions, cleaner air and a boost to wildlife.

Academics, investors, policymakers and corporates have recognised that the COVID-19 pandemic and the climate change emergency require integrated solutions. For ESG that is likely to mean a much larger focus given to social factors, without reducing the salience of environmental ones.

1. The **real economy** concerns the production, purchase and flow of goods and services (like oil, bread and labour) within an economy. It is contrasted with the financial economy, which concerns the aspects of the economy that deal purely in transactions of fiat money and other financial assets which represent ownership or claims to ownership of real sector goods and services.
2. The PRI works to understand the investment implications of environmental, social and governance (ESG) factors and to support its international network of investor signatories in incorporating these factors into their investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole. It is supported by, but not part of, the United Nations.
3. https://www.unpri.org/pri-blog/a-shield-against-covid-19-embedding-human-rights-in-investment/5732.article
4. https://www.unpri.org/pri-blog/covid-19-putting-the-economy-in-the-recovery-position/5638.article
5. https://www.unpri.org/5627.article
6. TCFD recommendations are for voluntary disclosures on climate related financial risk and opportunities.
7. FT Article 11 May 2020 – "Impact investing in unflashy causes gains ground in the pandemic era.
8. See speech by Andrew Bailey, Deputy Governor, Prudential Regulation and Chief Executive Officer, Prudential Regulation Authority – Culture in financial services – a regulator's perspective. 9 May 2016.
9. https://ec.europa.eu/clima/policies/eu-climate-action/law_en
10. FT Article 11 May 2020 – "Now is the time to emerge as a corporate 'saint' not 'sinner'.

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