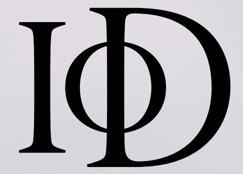

IoD CENTRE FOR CORPORATE GOVERNANCE PAPER

ESG – Where do we stand?

June 2023

Contents

Introduction 3

Beyond the balance sheet 4

The investor perspective 6

Consumer voice 7

Developing a new reporting landscape 8

Governance is king 9

Conclusion 10

Introduction

Consumers are willing to pay more for sustainable and ethically made products and there is more investment cash than ever available for companies with 'green' credentials to tap into. So why has the ESG (environment, social and governance) label become such a controversial and potentially divisive part of the business landscape?

As usual, there are some real issues for directors to wrestle with and others that have been overblown. There are legitimate concerns about ESG as an organising concept. It's arguably too imprecise and unfocused a concept, housing issues that are fundamentally different under one roof. Some may justifiably ask, what do greenhouse gas emissions (E), modern slavery (S) and audit (G) have in common?

ESG has also become increasingly politicised, particularly in the US, where the political right view social issues – such as racial justice and sexual orientation – as part of a progressive 'liberal' agenda that companies should not get involved in, labelling it 'woke capitalism'.

Beyond the balance sheet

In a recent Behind The Money podcast episode, 'ESG Reshapes The Boardroom', Financial Times journalist, Gillian Tett, outlined some of the big issues at the heart of the ESG debate[1]. She concluded that most big companies today recognise "the need to look at life beyond the balance sheet".

Tett noted there had been a shift away from the historical acceptance of American economist Milton Friedman's thinking, which insisted that the primary role of directors was to just focus on the creation of value for shareholders, through the pursuit of financial profits.

Friedman introduced his theory in a 1970 essay for The New York Times titled 'A Friedman Doctrine: The Social Responsibility of Business is to Increase Its Profits'. In it, he argued that a company has no social responsibility to the public or society (beyond obeying the law); its only responsibility is to its shareholders. The doctrine has been very influential in the corporate world from the 1980s to the 2000s.

However, it has also attracted criticism, particularly since the financial crisis of 2007–2008.

Since then, investors, politicians and regulators have favoured a move away from the strict orthodoxy of Friedman's shareholder first model, towards a 'stakeholder' approach.

This includes shareholders as a key stakeholder, but it also seeks to emphasise and reward directors for other things, such as environmental stewardship, employee satisfaction and diversity and inclusion.

The new approach was boosted in August 2019, when the Business Roundtable, a group of the CEOs of some of the biggest US companies, radically redefined its statement of the Purpose of a Corporation to include "a fundamental commitment to all of our stakeholders", not just shareholders[2].

In Britain, the Better Business Act Campaign (BBAC) is making similar strides towards its goal of changing the Companies Act 2006 on directors' legal duties[3]. Under section 172 of the Act, it currently states that directors must promote the company by prioritising the interests of shareholders[4]. Directors should 'have regard' to other factors, including the impact on other stakeholders, when making their decisions. But ultimately the success of the company is seen as synonymous with the best interests of shareholders.

The BBAC, which is backed by the IoD, believes this is an outdated legal formulation of modern business purpose. Reflecting the evolving views of its members[5], the IoD also believes the way to run a successful business is to promote the best interests of all stakeholders, including shareholders, and that this should be enshrined in company law.

Tett said: "I don't see anybody on the corporate landscape right now who is saying that they want to return to Milton Friedman's vision of the world and just look at shareholders. So, even though you're seeing some backlash against ESG right now, you're not seeing a return to the really narrow 1970s Milton Friedman vision, which raises the really big question of 'what next'?

1 https://www.ft.com/content/3eabb5a4-dfa2-48be-8439-82a0496bdc7b
2 https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans
3 https://betterbusinessact.org/
4 https://www.legislation.gov.uk/ukpga/2006/46/section/172/2011-04-22#:~:text=172Duty%20to%20promote%20the%20success%20of%20the%20company&text=(3)The%20duty%20imposed%20by,of%20creditors%20of%20the%20company.
5 https://www.thetimes.co.uk/article/most-firms-think-social-purpose-is-just-as-important-as-profit-txk887wtp

> I think that most big companies today recognise they need to look at life beyond the balance sheet, think about ways of making capitalism cleaner to make it more durable. But the question of how exactly you go about doing that is still being very hotly debated.

The investor perspective

It was all much simpler when ESG was introduced in a 2004 United Nations (UN) white paper, 'Who Cares Wins'[6]. This led to the 2006 UN Principles for Responsible Investment, which now has over 3,000 signatories that manage more than $3 trillion in assets.

ESG-related investment growth has rocketed over the last five or six years as a younger generation of consumers, fund managers and company decision makers push things forward. According to PwC's Asset and Wealth Management Revolution 2022 report, fund managers globally are expected to increase their ESG-related assets under management to $33.9 trillion by 2026, from $18.4 trillion in 2021. ESG assets are on course to hit 21.5% of total global assets under management in less than five years[7].

With so much money controlled by 'responsible' investors, it's not surprising the companies they own shares in face increasing pressure to be more ESG-friendly. This shift is partly down to the changing attitudes of the people investing – a new breed of investment manager, such as BlackRock, wants an element of social and environmental responsibility as well as the ability to make good financial returns.

A recent survey by Stanford Graduate School of Business, the Rock Centre for Corporate Governance, and the Hoover Institution polled 2,470 investors, which revealed sharp differences along generational lines, with younger shareholders saying they are far more eager to have fund managers pursue ESG objectives – and also far more willing to risk higher losses in the process[8].

6 https://www.unglobalcompact.org/docs/issues_doc/Financial_markets/who_cares_who_wins.pdf
7 https://www.pwc.com/gx/en/news-room/press-releases/2022/awm-revolution-2022-report.html
8 https://www.forbesindia.com/article/stanford/the-esg-generation-gap-millennials-and-boomers-split-on-their-investing-goals/84597/1

Consumer voice

The push for companies to be more ESG-friendly is not just coming from investors; customers are also voting with their wallets.

A recent report (February 2023) by McKinsey, the consulting giant, details how the growing appetite for more sustainable and ethically sourced products is a huge incentive for corporate suppliers to clean up their act.

In collaboration with NielsenIQ, the retail and consumer analytics firm, McKinsey analysed five years of US sales data, from 2017 to June 2022. The data covered 600,000 individual product lines, representing $400 billion in annual retail revenues. These products came from 44,000 brands across 32 food, beverage, personal-care, and household categories. It found that products making ESG-related claims accounted for 56% of all growth – about 18% more than expected. Also, products making these claims averaged 28% cumulative growth over the five-year period, versus 20% for products that made no such claims[9].

The survey was equally clear about the overall trend – in two-thirds of categories, products that made ESG-related claims grew faster than those that didn't. It added:

These claims must of course be backed by genuine actions that have a meaningful ESG impact, and companies should heed the serious warning about greenwashing ... It also indicates that brands might be wise to reflect on their commitment to ESG practices.

9 https://www.mckinsey.com/industries/consumer-packaged-goods/our-insights/consumers-care-about-sustainability-and-back-it-up-with-their-wallets

Developing a new reporting landscape

Despite these trends, the ESG 'brand' has become more contested in recent years, and is still viewed with suspicion by some in the boardroom. This is partly due to the proliferation of consultants, advisers, ratings agencies, data providers, aggregators, benchmarking and the tangle of different disclosure standards and sustainability frameworks. It is also easy to imagine why directors may wonder what the disparate parts of the ESG portfolio have in common.

There is a growing call for more standardisation in how companies across the world report ESG, particularly climate issues, in their accounts. This already happens for financial information, where there are well established and understood accounting rules.

Thankfully, new regulations are starting to emerge in the UK, US and Europe that attempt to make sense of the alphabet soup of standards that currently govern ESG reporting.

For example, the Task Force on Climate-related Financial Disclosures (TCFD) has developed a set of recommendations that are changing the way organisations manage climate risks and opportunities[10]. TCFD reporting requires companies to introduce a governance structure for climate-related risk and opportunities, review the transitional and material impacts of climate change and identify the right metrics to assess and manage these impacts.

60%

of the world's 100 largest public companies support the TCFD recommendations.

As part of the TCFD reporting requirements, all UK premium-listed companies have been required to state, in their annual report, whether their disclosures are consistent with TCFD recommendations, or to explain why not. This has been the case since 1 January 2021.

The UK Government has subsequently extended this requirement beyond listed companies. From April 2022, TCFD-aligned disclosure became mandatory for over, 1,300 of the largest UK-registered companies and financial institutions – the first G20 country to take this step. Europe is going further, introducing comprehensive reporting standards for all ESG, not just climate.

The US is also in the process of introducing compulsory climate disclosures for public companies. In addition, the sustainability agenda in the US has been boosted by President Biden's Inflation Reduction Act, which offers companies subsidies for green investments.

The Act – a 'green' version of former President Trump's America First plan to prioritise and protect US industry – includes approximately $369 billion for addressing climate change. It spans clean energy, transportation, and a host of other areas. The EU is starting to respond by offering similar incentives, while investors and company directors are waiting to see what the UK is going to do.

British businesses fear losing out to companies elsewhere, and there is a real danger that firms will be forced to turn their backs on the UK unless the government comes up with a similar package of incentives to keep manufacturers on these shores. Adrian Hallmark, chief executive of the luxury carmaker Bentley, owned by German giant Volkswagen, spoke for many in the British car manufacturing sector when he told the Financial Times that other countries are offering incentives that are "an order of magnitude more attractive than the UK".

10 https://www.fsb-tcfd.org/

Governance is king

In the Behind the Money podcast, Tett echoed the sentiments of many company directors – that the G doesn't really fit into the ESG framework.

"[Governance is] really about the internal processes of a company and not about the company's footprint on the world around it or the impact of the world on the company," she explained.

In the IoD's March 2023 Policy Voice survey, respondents favoured the G as being 'most important' to their organisation within ESG[11].

The votes were split as – 16.72% for environmental policy; 8.96% voted for social; 25.46% for governance; and 42.4% said they were equally important; with 6.45% voting don't know.

8.96%
Social

16.72%
Environmental

25.46%
Governance

42.4%
Equally important

The poll was encouraging, because in the public discourse about ESG there is rarely any talk about governance, compared with the higher profile issues that characterise the E and S.

This is an obvious cause for concern for directors because it suggests that unless it is separated, the G might be overlooked and risks being neglected – especially within the context of the so-called ESG ratings and index frameworks that have been developed in recent years. In fact, there is a good argument to be made that good governance should sit above the E and S, because well run companies make better decisions about the long-term health of a business. Furthermore, G is qualitatively different in that it is concerned with the processes of business decision-making rather than the decisions themselves. Tett noted:

> **If a company is run very badly, with no transparency, no risk management, and just one mercurial... CEO, then it's likely to have a much worse footprint on the world than others and likely to essentially be ill-equipped to cope with a changing environment. So I think people in the ESG space are increasingly looking at the G and saying that companies need to be well-run, not treated like individual fiefdoms.**

11 IoD Policy Voice survey, March 2023. Results on based on 915 responses from IoD members.

Conclusion

ESG is here to stay. It will change and evolve, but it is an area of business that directors should embrace – understand the challenges and manage the risks. In that respect, it's no different from a plethora of other challenges and opportunities that directors must take account of.

With this in mind, it's important that businesses take note of what has happened in the US and try to avoid some of the political posturing that has contaminated the ESG debate. This should allow directors to get on with making clear-headed, governance-based decisions to secure the long-term success of the company.

In his article, 'the End of ESG', Alex Edmans, professor of finance at the London Business School, summed up the state of play for directors and investors[12].

He said: "This title intends not to signal ESG's death, but ESG's evolution from a niche subfield into a mainstream practice. The biggest driver of this ascent is the recognition that ESG factors are critical to a company's long-term (financial) value. But then all executives and investors should take them seriously, not just those with 'sustainability' in their job title. Considering long-term factors when valuing a company isn't ESG investing; it's investing."

"A company's relationships with its employees, customers, communities, suppliers, and the environment are highly value relevant; there's nothing particularly cultish, liberal, or – dare I say it – 'woke' in considering them."

In other words, company directors should treat ESG like any set of other factors which can help create or destroy long-term value.

"It's nothing special since it's no better or worse than other intangible assets that create long-term financial and social returns, such as management quality, corporate culture, and innovative capability," he added.

Companies shouldn't be praised more for improving their ESG performance than these other intangibles; investor engagement on ESG factors shouldn't be put on a pedestal compared to engagement on other value drivers. We want great companies, not just companies that are great at ESG.

12 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4221990

The Institute of Directors is a non-party political organisation, founded in 1903, with approximately 20,000 members. Membership includes directors from right across the business spectrum, from media to manufacturing, professional services to the public and voluntary sectors. Members include CEOs of large corporations as well as entrepreneurial directors of start-up companies. The IoD was granted a Royal Charter in 1906, instructing it to "represent the interests of members and of the business community to government and in the public arena, and to encourage and foster a climate favourable to entrepreneurial activity and wealth creation." The Charter also tasks the Institute with promoting "for the public benefit high levels of skill, knowledge, professional competence and integrity on the part of directors", which the IoD seeks to achieve through its training courses and publications on corporate governance.

The IoD is an accredited Good Business Charter organisation.

iod.com

Authors:

Dr. Roger Barker
Director of Policy and Governance, IoD

Karl West
Senior Consultant, IoD