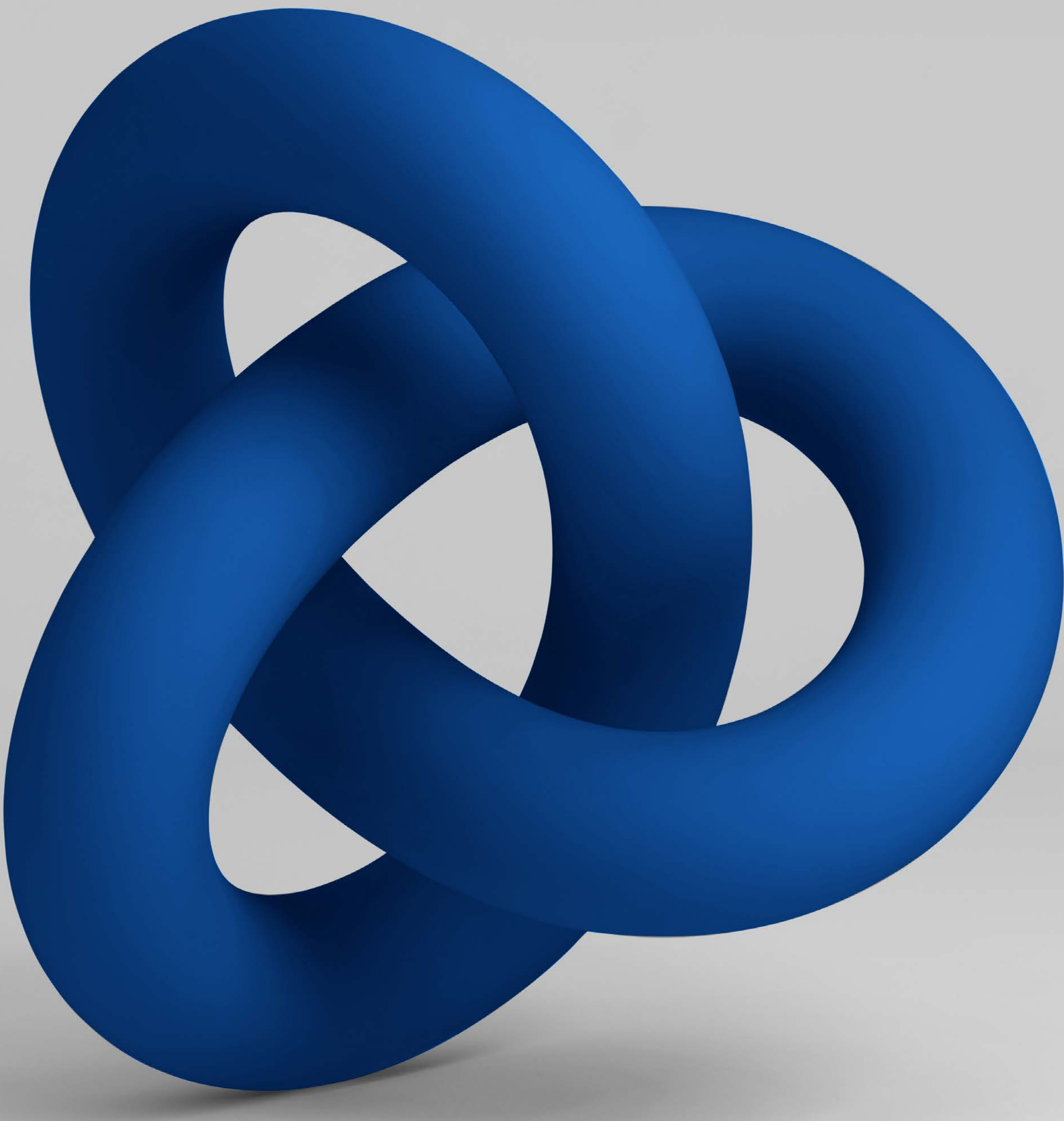
Baker McKenzie.



Trust Continuum

Sustainability and performance: Two sides of the same coin

At the beginning of this series we established that without trust, a company's license to operate is at risk, making long-term, sustainable value creation more challenging. Two main things are central to building trust — careful engagement with the company's key stakeholders as well as effective governance to ensure meaningful understanding and fulfillment of societal expectations. Companies that have a clear corporate purpose that is values-driven, accountable and transparent are better positioned to gain trust and enjoy longer term success. As key indicators of societal priorities, environmental, social and governance (ESG) concerns have taken on new importance in achieving trust and appropriately garnered greater attention on the board's agenda.

In this installment of the Trust Continuum series, we examine the connection between sustainability, governance and business performance. We focus on how and why corporations must operationalize environmental, social and governance (ESG) factors across the commercial organization and address the challenges of doing so. We contend that sustainability and business performance are two sides of the same coin and suggest that corporations must adopt comprehensive strategies that more closely connect sustainability to business impact. To achieve this objective, corporate leaders and the boards overseeing them must recognize the importance of sound stakeholder governance.

In this board paper:

1. What is ESG and how much it matters

What is ESG?

ESG evolved from corporate action; beginning as corporate philanthropy (giving money to worthy causes), progressing to Corporate Social Responsibility (CSR) (undertaking "do good" activities) and finally progressing to what we know as ESG today (doing well by doing good on issues that matter).[2] With CSR, or "doing good", there often was little or no board oversight. This progression has evolved into a wider understanding that a failure to "do" ESG well creates risk for companies, elevating its consideration to a board oversight matter.

The mantra, in this age of stakeholder capitalism, has now become, "doing well by doing good". Long term value maximization (rather than simply short term profit generation) is the currency of the moment. And it is now widely accepted that there is no inherent tension between creating value and serving the interests of employees, suppliers, customers, creditors, communities, and the environment. A clear corporate purpose and good stakeholder governance, which underlie effective ESG, are what boards must pursue.

Just how much does ESG matter?

Investors have arguably been the most recent (and among the loudest) proponents of ESG in the corporate world. BlackRock's Larry Fink's letter in 2018 set the challenge to address climate risk. Since then, there has been greater scrutiny on the accuracy and completeness of that reporting, in particular whether companies are addressing the ESG issues that matter to them sufficiently and whether they are doing so in a way that is appropriately revealing about their performance thereby facilitating third party evaluation.

Fink's letter comes at a time of great importance; one when entire teams have already been established to steward ESG at the world's largest asset managers and 75 per cent of public companies now report on some form of ESG goals.[3] These asset managers increasingly refer to the purpose of corporations being the pursuit of sustainable business strategies that take into account ESG factors in order to drive long-term value creation. And the proliferation of sustainable/ESG and similar funds speaks volumes about the breath of this perspective.

What do we mean by ESG?

Environmental, social and governance are recognized to be key factors companies need to consider in relation to long term value creation.

Environmental: Factors include risks and opportunities in relation to climate change, natural resources, clean energy and technology, pollution and waste.

Social: Factors include risks and opportunities in relation to human capital, community betterment, safety and security.

Governance: Factors include risks and opportunities in relation to responsible finance, diversity and equality, executive pay, ownership, compliance and controls.[1]

Notable Mentions of Stakeholder Capitalism

- Black Rock's Larry Fink's letter to shareholders highlighted the importance of company culture and commitment to stakeholders.[4]
- Business Roundtable Statement in the US in August 2019 expounded on ditching shareholder primacy to consider the needs of wider stakeholders.[5]
- British Academy's Principles for Purposeful Business establishes a mandate for companies to solve problems of people and planet with an emphasis of purposeful business.[6]
- Stakeholder capitalism was one of the World Economic Forum's key themes for Davos 2020, following on from the White Paper they published in March 2019 in collaboration with Baker McKenzie on the Modern Dilemma: Balancing Short- and Long-Term Business Pressures.[7]
- UK regulatory changes mean UK directors are required to include how they have exercised their fiduciary duties in annual reports.[8]
- A review of stewardship in the UK now focuses on investor engagement with companies on these topics and outcomes.[9]
- The Financial Times' microsite, Moral Money, features a weekly rollcall of "Saints & Sinners" in the unfolding COVID-19 landscape.[10]

Directors in most jurisdictions have always had fiduciary duties to act in the best interests of the corporations they serve — in the US this has historically been interpreted as a duty to maximize profit for shareholders. In the UK, the enlightened shareholder value approach means directors, when acting in the best interests of the company for the benefit of shareholders as a whole, must also take into account the interests of the company's other stakeholders and the company's long term prospects. And it is clear that in the recent past the language of investors is changing - from "returns" to "value creation", from "profit generation" to "resilience" – all accelerated by COVID-19.

Corporations also face growing pressure from their stakeholders to embed ESG practices and policies in their operations and governance, in particular from employees and customers. Several studies emphasize just how much employees, customers and investors value strong ESG.

70%

of US workers are more likely to choose a company with a strong environmental agenda[11]

33%

of employees had given more time and effort to a job because of their employer’s sustainability agenda

30%

said that they have left a job in the past because of the company’s lack of a sustainability plan

62%

of global environmental, social and governance-focused large-cap equity funds outperformed the MSCI World stock index in March 2020[12]

92%

of customers more likely to trust a company that supports social or environmental issues[13]

2. Sustainability strategy: Business considerations for determining ESG priorities and integrating sustainability as a core component of the business model

Challenges to be addressed

Operationalizing sustainability initiatives can be fraught with difficulty. What start out as individual “pet projects” become company-wide promises – a “bottom up” approach to developing a sustainability strategy. Such an approach can leave organizations exposed to challenges on performance metrics and managing multiple initiatives in a piecemeal manner.

Another business challenge is the fragmentation of regulatory requirements across jurisdictions – where companies are headquartered can determine what ESG standards are implemented and whether the wider company adopts global best practices in all markets. Without a consistent, strategic approach companies will undermine stakeholder trust and could miss critical opportunities to innovate.

Customization and fit matter as well. Corporations are like fingerprints — no two are the same, each with distinct cultures, stakeholders and priorities. For businesses, sustainability goals and initiatives should be similarly unique to the specific purpose and values of the organization and the expectations of its own stakeholders.

Risk and materiality assessment is crucial

There is also a need to undertake risk assessments to identify the ESG issues of moment to the enterprise. Risk or materiality assessments are imperative to identify the key or material ESG challenges and opportunities confronting the company as judged through the lens of the company's business purpose.

With that frame of reference, the enterprise can prioritize and apply resources to the issues that matter and structure the ESG program in accordance with those objectives. Given the rapidly evolving nature of ESG mandates, those determinations will need to be revisited regularly and be well understood by management and the board to ensure the company's program is optimally aligned with the company's purpose. Internal clarity about the ESG objectives and priorities will allow the company to properly structure its program to perform effectively. Such clarity will also assist in addressing the vexing challenges regarding how best to report and disclose information to stakeholders and the marketplace about the company's ESG plans and performance.

As part of the company's ESG assessment, it is important to review the constellation of reporting standards and frameworks and assess those of greatest impact and applicability to the company including the relative cost and benefit of different approaches in which it is useful to consider both the disclosures of other companies and the unique circumstances of the company.

Good governance is the best way forward

The most effective approach is to treat ESG as a method of risk mitigation, rather than multiple strategies or initiatives across the company in functional or regional silos. ESG should be part of a board's risk oversight agenda. For this, good corporate governance, the "G" is the key to success.

A company's corporate governance framework should establish the roadmap for governing environmental and social risks. For example, there is growing consensus from international and domestic regulators that climate risk is a financial risk, and should be managed as such.

The COVID-19 pandemic has led some commentators to suggest there needs to be an additional "E" for employees, who have arguably been the most critical corporate risk, from a health and business operations perspective. Others add that an "S" for stewardship is also critical, given the importance of investors' expectations of companies and their boards, and that such expectations align with what the directors' fiduciary duties require them to do. Lastly, it is important to integrate into this framework data governance, with data becoming an increasingly valuable asset of many companies.

Before COVID-19, there was already a clear movement of capital away from companies with unsustainable business models or a palpable disregard for ESG.[14] We are already seeing clear signs that this trend will almost certainly accelerate in the future.[15]

As stakeholders and society apply greater pressure to corporations, drawing together sustainability and business in meaningful ways will be critical to building trust.

Considerations for integrating sustainability into the business model

So how can companies address ESG in practice? We would suggest the following are key considerations for the company and for boards.

Theme	Consideration for the board	Consideration for the organization
Company purpose	· Does the company have a clear purpose?	· Is the company's purpose clearly communicated and understood across the organization as well as externally?
Company culture	· What type of culture does the board want to instill?	
Corporate Governance	· Does the company have a good governance framework in place, from the board and its decision making to that across the company? · Does the Board understand its fiduciary duties?	· Is the company adhering to the governance framework throughout the company and in making the right decisions?
Board/management	· Has the board incorporated the company's key stakeholders in its business model? · Is the board well informed, with the voice of each such stakeholders brought into the boardroom and considered as part of decision-making?	· Does management understand who the key stakeholders are to the company's long-term success and are the right tactics in place to engage with them and hear their views?
Risk and Materiality Assessment	· What impact do risk and materiality assessments have on boardroom discussions, reporting and decision-making?	· How can the company ensure it is prioritizing its attention on those ESG issues of greatest importance from a risk and opportunity perspective?
Value Creation and Resilience	· How well can the board articulate to its owners how it is using stakeholder governance to improve decision making and secure long term value creation as well as resilience during the crisis? · How is the company reporting to the board beyond returns to encompass value creation and resilience, in order to capture the engagement of investors and improve access to capital?	
ESG measuring and reporting	· How is success of the ESG agenda measured? Should companies value the risk of not acting on particular ESG aspects? · Can a value be put on the impact of ESG strategy and performance on the company’s financial performance (e.g. example, strategies aimed at cost-avoidance or at revenue-generation)? · Is the company's ESG strategy unique and differentiated in such a way that it can be a source of competitive advantage? · What will be reported and how such transparency be backed by appropriate assurance? · What incentives are in place across the whole company to help drive the ESG agenda? · What will be reported and how such transparency be backed by appropriate assurance?	

3. Looking forward: The challenge and opportunity of ESG reporting

How can the effectiveness of a company's ESG agenda be measured? Intense global discussion now centers on how to capture progress on ESG and report performance to the market in a standard way globally. The fragmented and often voluntary nature of reporting standards, where they exist, makes capturing positive impact difficult – and benchmarking this across industries is challenging.

There are a number of reporting standards to choose from – the Sustainable Accounting Standards Board, the Task Force on Climate-related Financial Disclosures and the Global Reporting Initiative being the most frequently used; there is also a plethora of Sustainability Reporting Tools (SRTs)[16] and many companies also refer to which UN Sustainable Development Goals they adhere to. The SDGs are good value barometers but not detailed enough to amount to reporting standards.

This lack of enforceable standard metrics and the accompanying necessary assurance makes it difficult to assess a corporation's ESG credentials. This challenge in turn leads to suggestions of green washing or conversely to claims of unfair rankings where measurements not appropriately tailored to the company are used. To this end, some say regulators must step in to set a common reporting framework and standards so that there is a level playing field for listed and non-listed companies of a certain size.

Doing so would enable executives to determine what to focus on, why this matters and how to report on progress. In the meantime, efforts are being made by corporates to achieve increased standardization and alignment of ESG and sustainability-related metrics, including through the World Economic Forum's International Business Council.[17]

Conclusion

As businesses begin to pivot, adjust and strategize in response to COVID-19, the urgency of establishing, integrating, measuring and reporting ESG practices cannot be understated. From the appreciation that standard global metrics are needed to measure companies' ESG credentials, more recently highlighted by how corporate reputations are being enhanced or damaged by the actions they take during COVID-19, ESG is clearly here to stay.

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