ESG in times of crisis and beyond

Tracing the contours of key major trends in climate change and the impact of the Covid-19 crisis on boardrooms

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During the past decades, corporate governance issues were front and centre. They have crystallised into many norms and practices, both internationally and in Switzerland. Say on pay is a chief example. Over the past five years, climate change has emerged as the next top priority in the environmental, social and governance (ESG) debate.

There has been a convergence of initiatives, recently rolled out or that will come to fruition in the next few years. Boards need to be well informed to assess the practical impact of investors' environmental focus and integrate climate change considerations into their strategic planning. The Covid-19 crisis could yet derail or put a brake on these initiatives. However, evidence is emerging that investors continue to apply pressure. In fact, the crisis may increase rather than reduce investor' focus on climate change issues.

The 2015 Paris Agreement

Climate change has dominated the ESG debate prior to the outbreak of the Covid-19 pandemic. In its 15th Global Risks Report, published in January 2020, the World Economic Forum ranked climate change as the biggest global threat. According to the United Nations, delays in tackling this issue could cost companies nearly US$1.2 trillion over the next 15 years.

The 2015 Paris Agreement on climate change has been the catalyst for many initiatives. As is well known, the 2015 Paris Agreement aims to keep a global temperature rise well below two degrees Celsius above pre-industrial levels and to pursue efforts to limit the temperature increase even further to 1.5 degrees Celsius. Importantly, the accord stresses the role of the financial markets as a key driver for changes. One of its tenets is to make finance flows consistent with a pathway toward low greenhouse gas emission and climate-resilient development.

The EU sustainable finance action plan

Boardrooms across the world, including Switzerland, need to pay attention to what is going on in the European Union. This is because the groundbreaking Action Plan on Sustainable Finance adopted by the European Commission in March 2018 is – as recognised in the March 2020 report of its Technical Expert Group – bound to have a significant impact on investors and companies around the world.

A cornerstone of the EU sustainable financial compact lies in a so-called taxonomy regulation. The goal of the EU is to create a framework for identifying to what degree economic activities of businesses can be considered to be environmentally sustainable. That framework has six main focus areas, ranging from climate change mitigation to the protection and restoration of biodiversity and ecosystems. Implementation will start in December 2021.

Large EU companies that are currently subject to so-called 'non-financial reporting requirements', such as environmental protection and social responsibility (about 6,000 large companies and groups across the EU) and many investors in the EU will be required to disclose how they align with the taxonomy, which will also be the basis for an EU green bond standard.

The end goal is that mandatory disclosure and inbuilt incentives influence the allocation of capital by boards and transitioning to carbon neutral activities. The possibility of creating a 'brown list' ('shaming' harmful economic activities) will also be considered.

Regulatory developments in Switzerland

In Switzerland, which saw sharp increases in sustainable investment in recent years, the new law on greenhouse gas that became effective on 1 January 2020 does not yet contain measures recognizing finance as an enabler of transformative changes.

In June 2020, the Swiss government published a report on sustainable finance taking position on a range of initiatives at the EU level. The government's end goal is to propel Switzerland to the forefront of sustainable finance. In keeping with the Swiss traditional approach, the government however places the main emphasis on market forces and self-regulation. In particular, the government's view is that legislation does not yet need to be introduced to create a taxonomy or consistent labeling of green financial products, among other key themes, all the while monitoring closely international and in particular EU developments.

Separately, the intensely debated 'Responsible Business Initiative', a popular legislative initiative, is likely to be voted upon later in 2020. The initiative proposes to delineate due diligence obligations requirements with respect to human rights and environmental standards. It also contemplates that companies be held liable for human rights and environmental harms caused anywhere within their global supply chain. To that extent, it goes much further than international standards and could have potentially far reaching ramifications for Switzerland-based multinationals and internationally active SMEs. On June 9, 2020 the Swiss parliament put forward a less onerous counterproposal, which will be voted upon in parallel with the popular initiative.

To date, the ESG reporting regime in Switzerland thus is voluntary. A company listed on the Swiss stock exchange SIX may 'opt into' the requirement to publish a sustainability report to be produced in accordance with internationally recognised standards. About one third of the SMI index, the blue chip index of the 20 largest companies listed on SIX, has opted in. SIX reviews compliance with the applicable standards. Despite the currently still soft approach of the Swiss lawmakers, boards of Swiss companies should fully appreciate that ESG standards are shaping up as a game changer for both the financial and non-financial industry.

Proliferation of standards

In parallel with regulatory initiatives, market pressure to tackle climate change has intensified, initiating an 'ESG cycle'. Socially responsible funds have sprung up. Influential index fund investors have turned up the heat on corporate purpose. Investors representing more than US$70 trillion of assets under management have signed up to the UN Principles for Responsible Investment. More than a dozen companies, such as ISS or Sustainalytics, issue ESG ratings.

In response to investors' demand, reporting standards and initiatives have proliferated. Boards should consider whether to sign up to these standards and how to incorporate relevant climate change input in their strategic decision-making. Some of these standards have been integrated, as shown for the SIX-listed

companies, in the rulebook of regulators or exchanges.

Two widely adopted reporting standards are those of the Taskforce on Climate Related Financial Disclosure ('TCFD'), established in 2016 by the Organisation for Economic Co-operation and Development (OECD) in the wake of the 2015 Paris Agreement, and the Sustainability Accounting Standards Board ('SASB'), the outcome of a six-year standard setting process.

The TCFD are principles-based reporting standards on governance, strategy, risk management, metrics and targets. In common with the EU approach, the underlying goal is to help channel investment to sustainable solutions and business models. The SASB has developed a complete set of 77 industry standards published in 2018. The standards focus on financially material information. They are used to implement principles-based frameworks, such as the TCFD.

Importantly for boards, these standards have been endorsed by a large number of companies, financial regulators (such as the Network for Greening the Financial System and IOSCO) and institutional investors. BlackRock, for example, is asking companies to disclose climate-related risks in line with TCFD and report along industry-specific guidelines of SASB by the end of 2020.

Impact of Covid-19

As businesses are battling the fallout of the pandemic, crisis management could be a brake on long-term climate change endeavors. This may however not be the case.

There is already evidence that investors continue to focus on ESG matters, including climate change, and that boards should continue to integrate ESG in their strategic decision-making. For example, BlackRock recently confirmed that the pandemic would not derail its plan to hold companies accountable on climate change and corporate governance issues. Even state-backed rescue financing in the airline industry, one of the hardest hit by the pandemic, has in certain cases come with environmental conditions attached.

In fact, the pandemic has not displaced the ESG debate. It has sharpened the social lens. As boards in Switzerland and around the world face hard choices as to, for example, prioritising the needs of employees, suppliers or shareholders in an environment of depressed or zero revenues, re-purposing production and tapping into emergency loans or other governmental support, institutional investors, such as State Street, have weighed in on the importance of the social impact of the pandemic.

On 27 March 2020, the UN Principles for Responsible Investment exhorted investors to engage with companies that are failing to protect employees' safety or their financial security. Institutional investors' focus is on whether boards are, among other things, unfairly restricting paid sick leave, laying off workers earlier than is necessary despite government support or failing to provide a safe working environment.

Similarly, in April 2020, the WEF endorsed six 'stakeholder principles' for the Covid-19 era, including keeping employees safe, securing share business continuity with suppliers and customers, ensuring fair prices for essential supplies, offering full support to governments and society and maintaining the long-term viability of companies for shareholders.

How boards handle the crisis, contribute to containing the pandemic and restructure executive compensation to take account of the fallout will be closely scrutinised by shareholders. For those companies that are subject to a binding say on pay vote, such as listed companies in Switzerland, it should be expected that these will be some of the key parameters considered by shareholders when asked to approve the executive compensation package.

Role of businesses

The ESG debate tackles pressing issues. Europe for example has to close a yearly investment gap of almost €180 billion to achieve EU climate and energy targets by 2030 according to the 2019 report of the European commission on climate and energy. That debate also mirrors a global shift in the concept of corporate purpose (narrowing the gap with those jurisdictions, like Switzerland, that have traditionally considered that fiduciary duties run to the company). Influential stakeholders are invoking the position statement on corporate purpose issued in 2019 by the prominent Business Roundtable signed by 181 CEOs of leading (mostly U.S.) companies. These chief executives committed to lead their companies for the benefit of all stakeholders (the statement cites, in this order, customers, employees, suppliers, communities and shareholders).

Concretely, boards have become widely sensitive to the tangible merits of pursuing ESG strategies, including the attraction and retention of talented and motivated workforce, improved resilience in the supply chain, reduced exposure to "transition risks", customer loyalty and reputation, all the while reducing risk of ESG activism and litigation.

Conclusion

Financial performance in 2020 and probably during subsequent years as well will be battered by the pandemic in many industries. 2020 may prove to be the litmus test for calibrating the importance that investors attach to climate change considerations during times of considerable stress. The pandemic may also have a long-lasting impact on the way companies structure their operations. This may entail changing existing processes in the light of ESG considerations to meet new expectations.

On the evidence provided by the market before the outbreak of the pandemic, positions taken by institutional investors in the midst of the crisis and rapidly evolving legislative actions worldwide, boards are well advised to continue to weigh carefully ESG and in particular climate change considerations in line with their core values.