

At risk? - How companies manage ESG issues at board level

Introduction

The turmoil of the current economic crisis is prompting a re-examination of the role of governments, regulators and investors in holding companies and, in particular, financial institutions to account. Good governance and transparency are crucial and increasingly investors are looking beyond the standard corporate governance issues to analyse how companies and boards manage environmental and social issues.

In this briefing EIRIS provides an overview of how companies in the FTSE All World Developed Index are managing environmental, social and governance (ESG) issues at board level and analyses how performance has evolved between 2005 and 2008.

Key Findings

- Companies have improved ESG risk management between 2005 and 2008 (with the average score of companies increasing by 7.4% against the EIRIS ESG management criteria and 10% fewer companies graded as showing little or no evidence)
- In 2008 a quarter of companies disclosed adequate risk management (achieving the good or advanced grade)
- Japanese companies demonstrate a notable improvement (19% increase in score) whereas very little change is seen in Australia and New Zealand (only improving by 0.4%)
- Financial sector shows the poorest performance of all of the sectors in 2008 (24.2% of companies disclose no evidence of ESG risk management which is at least twice that of any other sector)

Background

Corporate risk management and internal control mechanisms are important indicators of governance. The scope of risk management systems has evolved from a financial focus to a broader range of ESG issues. Incidents, such as the protests around Shell's disposal of the Brent Spar Oil Rig in 1995 brought to the attention of companies the importance of managing ESG issues and more recent incidents such as the BP Texas City refinery fire demonstrate the necessity of appropriate ESG risk management. Regulators in a number of countries have supported increased transparency and disclosure by companies of material ESG risks and opportunities, and how these are managed at board level, through the introduction of reporting guidance (see box on next page).

The financial crisis is an opportune moment to refocus on how companies are managing ESG issues. In 2008 the United Nations Global Compact issued a statement that 'if economic downturn leads to a critical evaluation of investments made in corporate responsibility, we expect to see a reinforcement of those efforts that treat environmental, social and governance issues as strategic imperatives for risk management'¹. The emergence of the Principals for Responsible Investment (PRI)², a joint initiative of the UNGC and United Nations Environment Programme Finance Initiative (UNEP-FI) has further increased the number of investors, both from the Responsible Investment and mainstream communities that are looking to better integrate ESG issues into investment decision-making.

Sample of global ESG guidelines

- **Europe:** EU Accounts Modernisation Directive requires that medium and large companies report information that 'should not be restricted to the financial aspects of the company's business. It is expected that, where appropriate, this should lead to an analysis of environmental and social aspects necessary for an understanding of the company's development, performance or position'³
- **Denmark:** the country's largest 1,100 companies are legally required to include information on corporate social responsibility in their annual report from 2010⁴
- **Japan:** Nippon Keidanren amended 'The Keidanren Charter for Good Corporate Behaviour' in 2002 and added an emphasis on building compliance and working to develop consumer trust⁵. Additional guidance for was provided in 2007⁶
- **South Africa:** 1994 King Report (and the updated King Report II in 2002 and King III released in draft in 2009) advocates good governance and a requirement for consideration of ESG issues^{7 8}

A review of the FTSE All World Developed Index

EIRIS has analysed the ESG risk management strategies of companies in the FTSE All World Developed Index between 2005 and 2008⁹.

The analysis focuses on how well companies are addressing ESG risks under four headings covering:

- Board responsibility
- Risk management systems
- Identification of ESG risks
- Potential liabilities and opportunities

Indicators include whether the board regularly reviews ESG risks and whether policies and procedures related to ESG risk are in place. EIRIS focuses primarily

on those ESG risks and opportunities identified by the company itself. Companies' overall management response is assessed as one of five grades from 'no evidence' to 'advanced' where a 'good' grade is considered to represent a company adequately managing its ESG risks. Each of the four separate components – board responsibility, risk management systems, ESG risk identification and potential liabilities and opportunities - are assessed in five bands – 0%, up to 25%, up to 50%, up to 75% and 100% - based on the number of total scores a company can achieve in each of the four areas.

Key findings of our research are highlighted below:

1) Japanese companies demonstrate the strongest performance

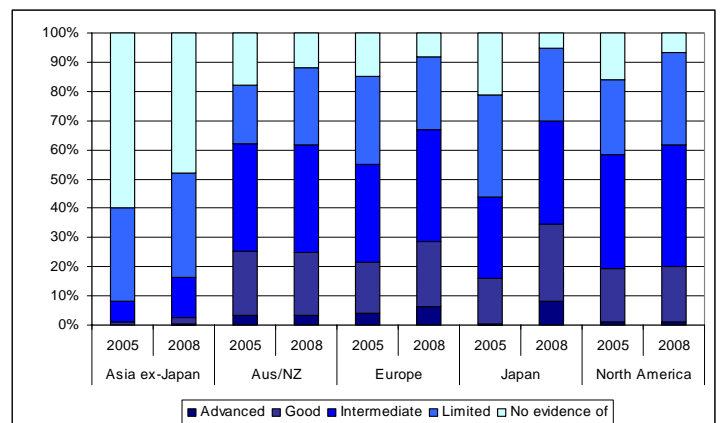


Figure 1 – Regional comparison of companies' ESG risk management

Overall only 4.5% of companies achieved the advanced grade against the EIRIS criteria for managing ESG risks. Whether considered by sector or region, improvements in management performance have been observed between 2005 and 2008 - and there is a particularly notable improvement for Japanese companies.

In 2005 companies in the Australia and New Zealand performed best against the ESG criteria, however in 2008 Japanese companies were the best performers

followed by European and North American companies. Japanese companies also demonstrated a significant improvement in performance increasing their score overall by 19%; more than twice the increase of any of the other region. Significant improvements by European (+8.8%) companies and to a lesser extent North America (+4.2%) meant that in 2008 companies from these regions performed better than companies from Australia and New Zealand. Companies in Australia and New Zealand improved performance by only 0.4% and companies in Asia ex-Japan improved by just 1.2%. Asia ex-Japan was the worst performer in 2005 and remained the worst performer in 2008 with 35% of companies achieving only the limited grade in 2008 and 48% assessed as providing little or no evidence. However, it is worth noting that there are always leaders and laggards and this is highlighted by one company in Hong Kong scoring 'advanced' and 100% for liabilities and opportunities section.

There is often considerable variation within a region. For example, in Europe 47.2% of French companies scored 'good' or 'advanced' against the ESG criteria while only 17.39% of Belgian companies scored 'good' and none scored 'advanced'. In North America, Canadian companies performed better than the US companies with 31.7% of Canadian companies achieving 'good' or 'advanced' compared to 18.6% of US companies.

On a positive note, improvements have been observed in all sectors between 2005 and 2008, however companies still have a considerable distance to travel to better integrate ESG risk management.

2) Financial sector demonstrates poor performance in ESG risk management

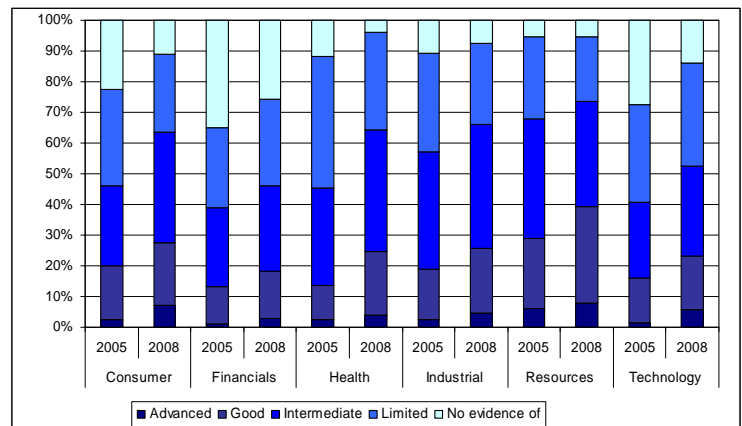


Figure 2 – Sector comparison of companies' ESG risk management

The financial sector shows the weakest performance on ESG risk management at board level with barely a sixth (15.1%) of companies being assessed as 'good' or 'advanced'. The financial sector also showed the smallest improvement between 2005 and 2008 with just a 4.2% increase in score.

The financial sector performs poorly in all four areas (board practice, ESG risk management, identification of ESG risks and quantified potential liabilities and opportunities). This may be a result of poor disclosure or more worryingly, the failure of financial institutions to recognise the relevance of considering ESG risks.

Technology was the worst performing sector in 2005 but improved more than any other sector (9.5%) by 2008. In both 2005 and 2008 the resources sector was the best performer (with gas, water and multi-utilities performing best within the sector) with 41.5% of companies scoring either 'good' or 'advanced'.

3) Companies perform well on ESG risk identification but poorly on management

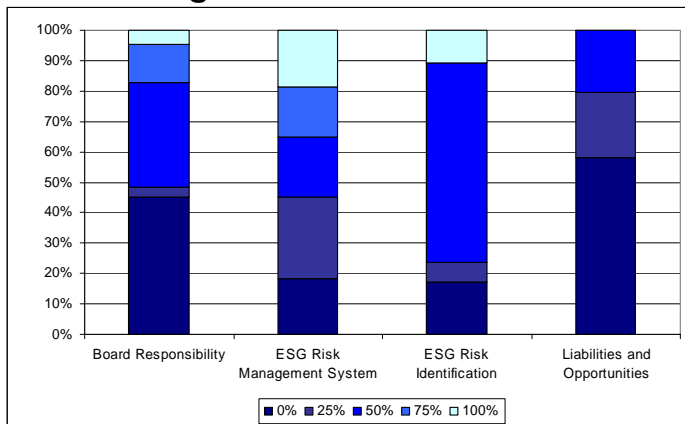


Figure 3 – Company performance against the four areas of ESG risk management

Board responsibility: A large proportion (45.3%) of companies display no evidence of board responsibility for ESG management; however over a third of companies (34.7%) achieve over 50% for this area. Guidelines such as the Association of British Insurer’s (ABI) on Responsible Investment Disclosure in the UK recommend a regular review of ESG risks by the board of directors; with 52% of companies in the UK achieving over 50% for this area. Board responsibility overall has shown the least improvement between 2005 and 2008 with an increase of just 4% of companies achieving 50% or above.

ESG risk management: Company performance is relatively evenly split between each of the performance bands. However between 2005 and 2008 there was a 26% increase in the number of companies scoring at least 25% of the maximum score indicating that companies are indeed increasingly disclosing the ESG issues relevant to their businesses.

Identifying ESG risk: Despite this being the strongest area of performance only 10.6% of companies achieve the full 100% score. This area has seen considerable improvement between 2005 and 2008 with 48.2% of

companies achieving at least 50% of the possible score in 2005 compared with 76.2% of companies in 2008.

Liabilities and opportunities:

Companies have provided the weakest response in the area of disclosing liabilities or opportunities related to ESG risks. However, this is also the area of greatest improvement between 2005 and 2008 with 2.6% of companies gaining 75% or higher in 2005 compared with 20.5% in 2008. In part this may be driven by the developments in environmental accounting which facilitate the quantification of environmental risks supported by initiatives such as the Carbon Disclosure Project which encourages companies to disclose the quantified risks and opportunities associated with climate change.

Looking forward

As Herman Mulder, former Head Group Risk Management ABN AMRO (1998-2006) and initiator of the Equator Principles, states ‘the world requires values based, socially responsible, sustainable strategies to be developed by governments and business, banks included; poverty, climate, water, human rights, social and economic inclusion, corruption are some of the major issues which need to be addressed with the same sense of urgency and priority as the current financial crisis and economic recession. Moreover, the adoption of such strategies by banks will help in rebuilding the trust and confidence of its stakeholders’.¹⁰

ESG risk management is not just an issue for financial institutions but for all companies and their shareholders. Investors, both from the Responsible Investment and mainstream communities, are increasingly looking to companies to better integrate ESG issues into their business decisions and this trend is likely to continue.

The Principles for Responsible Investment (PRI) provide impetus for investors to give greater consideration to ESG risks and provide better disclosure of ESG matters.

EIRIS PRI toolkit

Recognising the challenges that committing to the UN Principles for Responsible Investment represents for investment managers and asset owners, EIRIS has developed a toolkit that offers practical solutions for investors looking to implement the UN PRI, and in particular Principles 1, 2 and 3. The EIRisk tool assigns companies an ESG risk management grade that can be integrated into investment analysis and decision making processes. It helps investors meet their commitments under Principle 1 of the PRI. The Global Compact Engager assists investors who have adopted an engagement strategy, and meet their commitments under Principle 2 of the PRI. The Report Monitor focuses exclusively on companies' reporting practices to assist signatories to identify leaders and laggards on ESG disclosure, and meet their commitments under Principle 3 of the PRI.

Notes

1. (2008) 'The Global Economic Downturn – Why the UN Global Compact and Corporate Sustainability are needed more than ever' www.unglobalcompact.org/NewsAndEvents/news_archives/2008_10_17.html downloaded 04/12/2008
2. http://www.unpri.org/media/PRI_media_release_29-04-07.php downloaded 23/03/2009
3. Directive 2003/51/EC of the European Parliament and of the Council of 18 June 2003 <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2003:178:0016:0022:EN:PDF> downloaded 01/04/2009
4. (10/03/2009) 'Non-Financial reporting – Danish reporting rules' *Ethical Corporation*, <http://www.ethicalcorp.com/content.asp?ContentID=6385>, downloaded 23/03/2009
5. CSR Japan, CSR Archives, http://www.jri.co.jp/thinktank/sohatsu/csrjapan/index_e.html, downloaded 23/12/2008
6. Nippon Keidanren <http://www.keidanren.or.jp/english/policy/csr/outline.html>, downloaded 23/12/2008
7. 'King Report on Corporate Governance For South Africa' http://www.accaglobal.com/publicinterest/activities/policy_papers/archive/corporate_governance/255010 downloaded 15/01/2009
8. 'Draft King III at a Glance' http://www.pwc.com/za/eng/pdf/pwc_Draft-KingIII_2009.pdf downloaded 20/03/2009
9. The number of companies in the EIRIS universe between 2005 and 2008 has increased (most notably the 2005 data for North America covered only Canada whereas in 2008 the data covers Canada and the United States). In order to make the results from 2005 and 2008 comparable results have been averaged over the number of companies in the relevant category
10. Mulder (18/01/2009) 'Values'-Based, Sustainable, Responsible Banking: More Than Ever.....Time To Scale' By: Herman Mulder, Independent Advisor, former Head Group Risk Management ABN AMRO (1998-2006), initiator of the Equator Principles
11. (2008) A Closer Look at Business Education: Finance Faculty reflect on the Financial Crisis, *The Aspen Institute Centre for Business Education*, <http://www.aspenbce.org/documents/E-newsletter/December%2008/Closer%20Look%20-%20Finance%20-%20Financial%20Crisis.pdf>, downloaded 23/12/2008

About EIRIS

EIRIS is a leading global provider of independent research into the environmental, social, and governance, (ESG), and ethical performance of companies. With over 25 years experience of conducting research and promoting responsible investment strategies, EIRIS now provides services to more than 100 asset owners and asset managers globally.

In the last ten years new EIRIS research has focussed on the risks and exposure of companies in key ESG areas, and how companies are responding. EIRIS works with clients to create their own ESG ratings and rankings, to engage with companies and to create specific funds for their clients. EIRIS has a multinational team of over 50 staff in London, together with offices in Boston and Paris. The EIRIS network includes research organisations in Australia, France, Israel, Germany, Spain and South Korea, and now covers over 2,800 companies globally.

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