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ESG and corporate purpose in a disrupted world

Introduction

Even before the world was disrupted by COVID-19 and current events calling for a greater focus on social justice, corporate America was already at an inflection point with respect to its role in society, facing louder and more widespread calls for businesses to consider a broader range of stakeholders. From the groundswell of support for shareholder proposals on environmental and social matters starting in 2017,[1] to the August 2019 statement of the Business Roundtable,[2] to continuing pressure from prominent members of the investment community, the conversation on the purpose of the corporation has continued to gain momentum. While it remains to be seen whether we are witnessing a permanent transition from the primacy of shareholder capitalism to the inclusion of stakeholder capitalism, the above and other developments have had a profound impact on the corporate community's approach to environmental, social, and governance (ESG) issues. In addition to increasing demands of primary stakeholders, defining and integrating corporate purpose and ESG objectives will require companies to evaluate a wide range of decisions through a multistakeholder lens, leading corporations to prioritize groups that once might have been viewed as nontraditional or secondary stakeholders: employees, customers, suppliers, communities, and other affiliations.

1. https://corpgov.law.harvard.edu/2017/07/12/shareholder-proposal-developments-during-the-2017-proxy-season.
2. https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans.

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Early in the pandemic, some questioned whether, how, and to what extent companies would embrace and sustain commitments to ESG principles and corporate purpose.[3] However, if it was not clear early on, the pandemic and the social justice movement have magnified the effect that environmental and social forces can have on business, emphasizing the impact of ESG on strategy and risk. For board members, the oversight of strategy and risk are key elements of how fiduciary duties are executed. It is, therefore, critical that board members understand how corporate purpose and ESG principles are considered and effectively integrated into the strategy and enterprise risk management efforts of the companies they serve. Likewise, it is essential that directors also understand the opportunities afforded to companies that remain true to their corporate purpose and ESG strategies to be rewarded by the market for demonstrating greater resilience and preparedness for the next crisis.

Words matter: Some definitions

Due to the rapid pace of change in ESG and corporate purpose, the vocabulary used to discuss these and related areas is still developing. The terminology can be unclear, confusing, or both and can lead to unrealistic expectations about corporate behaviors and actions. For purposes of this article, here are some key terms and their meanings:

ESG	"Environment, Social, and Governance." While the meaning of "environment" and "governance" may be obvious, "social" may not be. "Social" refers to a broad swath of matters, ranging from human capital management and workforce issues to human rights to the company's role in society. In fact, because ESG is such a broad term, some have suggested adding an additional "E" for "employees" or "D" for "diversity."[4]
Sustainability	"Sustainability" is often used to refer solely to environmental matters such as climate change, but the term can also refer to what it takes for an enterprise to achieve long-term existence, profitability, and growth. Thus, sustainability is not synonymous with ESG; rather, it encompasses ESG, because all three elements of ESG contribute to the sustainability of the enterprise.
Corporate purpose	Corporate purpose, or corporate social purpose, refers to a company's stated role in society, connected to long-term value, and how the company fulfills that role in the communities in which it operates. It is a concept that involves proactive engagement in society on a broad range of social and, in some cases, political initiatives and answers the question "why is the company in business, and how will it stay in business and remain relevant?" As the company's stakeholders seek to understand more about how the company defines and executes its purpose, it is likely that purpose will be inextricably aligned with the company's ESG measurement and disclosure strategy.
Stakeholder capitalism	For many years, the interests of the corporation in a capitalist society were deemed identical with those of its stockholders. Under this approach, known as "shareholder capitalism," substantially all corporate decisions were based on whether and the extent to which the decision would benefit stockholders. In August 2019, the Business Roundtable[5] and others have suggested that companies need to consider the interests of all stakeholders—including employees, customers, suppliers, and their communities, as well as stockholders and investors. This approach is generally referred to as "stakeholder capitalism."

Corporate purpose and ESG as tools to reframe pandemic-related disruption

The links between ESG, company strategy, and risk have never been clearer than during the COVID-19 pandemic, when companies have had to quickly pivot and respond to critical risks that previously were not considered likely to occur. The World Economic Forum's Global Risks Survey 2020,[6] published in January 2020, listed "infectious diseases" as number 10 in terms of potential economic impact, and did not make the top 10 list of risks considered to be "likely." The impact of the pandemic was further magnified by the disruption it created for the operations of companies and their workforces, which were forced to rethink how and where they did business virtually overnight.

3. https://www.wsj.com/articles/sustainability-was-corporate-americas-buzzword-this-crisis-changes-that-11588352181.
4. https://fortune.com/2020/06/11/diversity-inclusion-investing-esg-esgd.
5. https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans.
6. https://www.weforum.org/reports/the-global-risks-report-2020.

The radical recalibration of risk in the context of a global pandemic further highlights the interrelationships between long-term corporate strategy, the environment, and society. The unlikely scenario of a pandemic causing economic disruption of the magnitude seen today has caused many companies—including companies that have performed well in the pandemic—to reevaluate how they can maintain the long-term sustainability of the enterprise. While the nature and outcomes of that reevaluation will differ based on the unique set of circumstances facing each company, this likely means reframing the company's role in society and the ways in which it addresses ESG-related challenges, including diversity and inclusion, employee safety, health and well-being, the existence of the physical workplace, supply chain disruptions, and more.

ESG factors are becoming a key determinant of financial strength. Recent research shows that the top 20 percent of ESG-ranked stocks outperformed the US market by over 5 percentage points during a recent period of volatility.[7] Twenty-four out of 26 sustainable index funds outperformed comparable conventional index funds in Q1 2020.[8] In addition, the MSCI ACWI ESG Leaders Index returned 5.24 percent, compared to 4.48 percent for the overall market, since it was established in September 2007 through February 2020.[9] Notably, BlackRock, one of the world's largest asset managers, recently analyzed the performance of 32 sustainable indices and compared that to their non-sustainable benchmarks as far back as 2015. According to BlackRock the findings indicated that "during market downturns in 2015–16 and 2018, sustainable indices tended to outperform their non-sustainable counterparts."[10] This trend may be further exacerbated by the effects of the pandemic and the social justice movement.

Financial resilience is certainly not the only benefit. Opportunities for brand differentiation, attraction and retention of top talent, greater innovation, operational efficiency, and an ability to attract capital and increase market valuation are abundant.[11] Companies that have already built ESG strategies, measurements, and high-quality disclosures into their business models are likely to be well-positioned to capitalize on those opportunities and drive long-term value postcrisis.

As businesses begin to reopen and attempt to get back to some sense of normalcy, companies will need to rely on their employees, vendors, and customers to go beyond the respond phase and begin to recover and thrive.[12] In a postpandemic world, this means seeking input from and continuing to build and retain the confidence and trust of those stakeholder groups.[13] Business leaders are recognizing that ESG initiatives, particularly those that prioritize the health and safety of people, will be paramount to recovery.[14]

What are investors and other stakeholders saying?

While current events have forced and will likely continue to force companies to make difficult decisions that may, in the short term, appear to be in conflict with corporate purpose, evidence suggests that as companies emerge from the crisis, they will refresh and recommit to corporate purpose, using it as a compass to focus ESG performance.[15] Specific to the pandemic, the public may expect that companies will continue to play a greater role in helping not only employees, but the nation in general,[16] through such activities as manufacturing personal protective equipment (PPE), equipment

7. https://www.livewiremarkets.com/wires/what-are-companies-doing-to-tackle-the-crisis.
8. "Sustainable Funds Weather the First Quarter Better Than Conventional Funds," Morningstar, April 2020.
9. "Mercer: COVID-19 elevates the value of responsible investing," Responsible Investor, April 2020.
10. https://www.blackrock.com/corporate/about-us/sustainability-resilience-research.
11. https://www2.deloitte.com/content/dam/Deloitte/us/Documents/strategy/us-cons-ops-social-purpose-and-value-creation.pdf.
12. https://www2.deloitte.com/us/en/insights/economy/covid-19/heart-of-resilient-leadership-responding-to-covid-19.html.
13. https://corpgov.law.harvard.edu/2020/06/08/stakeholder-capitalism-and-the-pandemic-recovery.
14. https://fortune.com/2020/06/01/will-the-pandemic-accelerate-stakeholder-capitalism.
15. https://corpgov.law.harvard.edu/2020/05/31/corporate-governance-update-eesg-and-the-covid-19-crisis.
16. https://www.bloomberg.com/opinion/articles/2020-05-04/covid-19-puts-others-at-the-table-with-shareholders.

needed to treat COVID-19 patients, and retooling factories to produce ventilators, hand sanitizer, masks, and other items needed to address the pandemic. In some cases, decisions may be based upon or consistent with ESG priorities, such as decisions regarding employee health and well-being. From firms extending paid sick leave to all employees, including temporary workers, vendors, and contract workers, to reorienting relief funds to assist vulnerable populations, examples abound of companies demonstrating commitments to people and communities.[17] As companies emerge from crisis mode, many are signaling that they will continue to keep these principles top of mind.[18] This greater role is arguably becoming part of the "corporate social contract" that legitimizes and supports the existence and prosperity of corporations.

In the United States, much of the current focus on corporate purpose and ESG is likely to continue to be driven by investors rather than regulators or legislators in the near term. Thus, it's important to consider investors' views, which are still developing in the wake of COVID-19 and other developments.

Investors have indicated that they will assess a company's response to the pandemic as a measure of stability, resilience ,and adaptability. Many have stated that employee health, well-being, and proactive human capital management are central to business continuity. Investor expectations remain high for companies to lead with purpose, particularly during times of severe economic disruption, and to continue to demonstrate progress against ESG goals.

State Street Global Advisors president and CEO Cyrus Taraporevala, in a March 2020 letter to board members, emphasized that companies should not sacrifice the long-term health and sustainability of the company when responding to the pandemic. According to Taraporevala, State Street continues "to believe that material ESG issues must be part of the bigger picture and clearly articulated as part of your company's overall business strategy."[19] According to a recent BlackRock report, "companies with strong profiles on material sustainability issues have potential to outperform those with poor profiles. We believe companies managed with a focus on sustainability may be better positioned versus their less sustainable peers to weather adverse conditions while still benefiting from positive market environments."[20]

In addition to COVID-19, the recent social justice movement compels companies to think holistically about their purpose and role in society. Recent widespread protests of systemic, societal inequality leading to civil unrest and instability elevate the conversation on the "S" and "G" in ESG. Commitments to the health and well-being of employees, customers, communities, and other stakeholder groups will also require corporate leaders to address how the company articulates its purpose and ESG objectives through actions that proactively address racism and discrimination in the workplace and the communities where they operate. Companies are responding with, among other things, statements of support for diversity and inclusion efforts, reflective conversations with employees and customers, and monetary donations for diversity-focused initiatives.[21] However, investors and others who are pledging to use their influence to hold companies accountable for meaningful progress on systemic inequality will likely look for data on hiring practices, pay equity, and diversity in executive management and on the board as metrics for further engagement on this issue.[22]

What can boards do?

Deloitte US executive chair of the board, Janet Foutty, recently described the board as "the vehicle to hold an organization to its societal purpose."[23] Directors play a pivotal role in guiding companies to balance short-term decisions with long-term strategy and thus must weigh the needs of all stakeholders while remaining cognizant of the risks associated with each decision. COVID-19 has underscored the role of ESG principles as central to business risk and strategy, as well as building credibility and trust with investors and the public at large. Boards can advise management on making clear, stakeholder-informed decisions that position the organization to emerge faster and stronger from a crisis.

17. https://www.forbes.com/sites/blakemorgan/2020/03/17/50-ways-companies-are-giving-back-during-the-corona-pandemic/#157c98114723.
18. https://corpgov.law.harvard.edu/2020/05/31/corporate-governance-update-eesg-and-the-covid-19-crisis.
19. https://www.ssga.com/us/en/individual/etfs/insights/stewardship-engagement-guidance-to-companies-in-response-to-covid-19.
20. https://www.blackrock.com/corporate/about-us/sustainability-resilience-research.
21. https://www.wsj.com/articles/ceos-and-big-businesses-speak-out-on-racism-police-violence-11591050109.
22. https://fortune.com/2020/06/11/diversity-inclusion-investing-esg-esgd.
23. https://www2.deloitte.com/content/dam/Deloitte/ca/Documents/finance/COVID-19-and-the-board-chair-point-of-view.pdf.

It has been said before that those companies that do not control their own ESG strategies and narratives risk someone else controlling their ESG story.[24] This is particularly true with regards to how an organization articulates its purpose and stays grounded in that purpose and ESG principles during a crisis. Transparent, high-quality ESG disclosure can be a tool to provide investors with information to efficiently allocate capital for long-term return. Boards have a role in the oversight of both the articulation of the company's purpose and how those principles are integrated with strategy and risk.

As ESG moves to the top of the board agenda, it is important for boards to have the conversation on how they define the governance structure they will put in place to oversee ESG. Based on a recent review, completed by Deloitte's Center for Board Effectiveness, of 310 company proxies in the S&P 500, filed from September 1, 2019, through May 6, 2020, 57 percent of the 310 companies noted that the nominating or governance committee has primary oversight responsibility, and only 9 percent noted the full board, with the remaining 34 percent spread across other committees. Regardless of the primary owner, the audit committee should be engaged with regard to any ESG disclosures, as well as prepared to oversee assurance associated with ESG metrics.

Conclusion

The board's role necessitates oversight of corporate purpose and how corporate purpose is executed through ESG. Although companies will face tough decisions, proactive oversight of and transparency around ESG can help companies emerge from recent events with greater resilience and increased credibility. Those that have already embarked on this journey and stay the course will likely be those well-positioned to thrive in the future.

24. https://www2.deloitte.com/content/dam/Deloitte/us/Documents/center-for-board-effectiveness/on-the-boards-agenda-front-line-of-esg-disclosure.pdf.

Questions for the board to consider asking:

1. How are the company's corporate purpose and ESG objectives integrated with strategy and risk?
2. Has management provided key information and assumptions about how ESG is addressed during the strategic planning process?
3. How is the company communicating its purpose and ESG objectives to its stakeholders?
4. What data does the company collect to assess the impact of ESG performance on economic performance, how does this data inform internal management decision-making, and how is the board made aware of and involved from a governance perspective?
5. Does the company's governance structure facilitate effective oversight of the company's ESG matters?
6. How is the company remaining true to its purpose and ESG, especially now given COVID-19 pandemic and social justice issues?
7. What is the board's diversity profile? Does the board incorporate diversity when searching for new candidates?
8. Have the board and management discussed executive management succession and how the company can build a diverse pipeline of candidates?
9. How will the company continue to refresh and recommit to its corporate purpose and ESG objectives as it emerges from the pandemic response and recovery and commit to accelerating diversity and inclusion efforts?
10. How does the company align its performance incentives for executive leadership with attaining critical ESG goals and outcomes?

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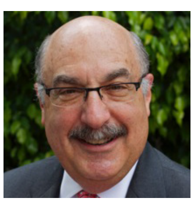

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