RISK BEYOND 2024

ERMA INTERNATIONAL CONFERENCE ON ERM

Sustainable Symphony: Echoes of Change

Business & Investment Responsibility

Navigating the Sustainable Investment Landscape

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ERMA

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- Theory and Practice of Stewardship and Sustainability
- Corporate Governance and Sustainability
- Managing Stewardship Responsibilities

- **Theory and Practice of Stewardship and Sustainability**
- Corporate Governance and Sustainability
- Managing Stewardship Responsibilities

What is Investor Stewardship?

Defining Stewardship

Dictionary: the responsible management of something entrusted to one's care…the proper use of entrusted power.

Investment: exercising share-ownership rights responsibly to oversee companies through monitoring, voting and engagement.

Company: accountability of the Board of Directors to investors to ensure good corporate governance and long-term corporate success.

"Stewardship is about preserving and enhancing ***long-term value*** *as part of a responsible investment approach. This includes the consideration of wider ethical environmental and social factors as core components of fiduciary duty. In a broader context* ***stewardship enhances overall financial market stability and economic growth****."*

ICGN Global Stewardship Principles, Preamble (2016)

Recent Decades have Witnessed an Ownership Revolution

- ***Institutional Investors***:
  - Rising levels of institutional ownership fuelled by pension explosion
  - 80% in US; in UK, individuals held 54% in 1963, but just 10% today
  - In Japan, over 30% of Tokyo Stock Exchange market capitalization is held by
  - overseas institutional investors
- ***Rise of Activist Investors***:
  - Hybrid of private equity style scrutiny in public markets
  - Concerns relate to short-termism
- ***Social Media***:
  - Growing scrutiny of companies and boards, especially on ethical, environmental and social issues
  - Stakeholders (employees, customers, communities) and civil society have a stronger voice

Institutional Investors Feels the Heat

Japan Ministry for Economic Trade and Industry (2008)

"To be blunt, shareholders in general do not have the ability to run a company. They are fickle and irresponsible. They only take on a limited responsibility, but they greedily demand high dividend payments."

Walker Review of Corporate Governance of the UK Banking Industry (2009)

'…strengthening the role of non-executives and giving them new responsibilities to monitor risk and remuneration; it also recommends a stewardship duty on institutional shareholders to play a more active role as owners of businesses.'

EU Shareholder Rights Directive 2 (2018)

"There is clear evidence that the current level of 'monitoring' of investee companies and engagement by institutional investors and asset managers is often inadequate and focus too much on short-term returns, which may lead to suboptimal corporate governance and performance."

Stewardship Codes

Political Response: Evolution of Stewardship Guidance

1995	Cadbury Code: Corporate Governance
1995	ICGN Statement on Institutional Shareholder Responsibilities
2003	UK Institutional Shareholder Committee statement on investor responsibilities
2008	Global financial crisis!
2010	UK Stewardship Code launched by the Financial Reporting Council
2014	Principles for Responsible Institutional Investors, Japan
2015	G20/OECD Principles of Corporate Governance (revised from 1999, 2004)
2016	ICGN Global Stewardship Principles
2016	Global Network of Stewardship Code Developers
2017	European Commission Shareholder Rights Directive
2018	European Sustainable Finance Initiative

Stewardship Codes Proliferate

ICGN
Global Stewardship Principles

ICGN Global Stewardship Principles

- Single source of international reference for investors, with globally diversified portfolios, to use as a benchmark when updating their in-house stewardship policies.
- Enhance dialogue between companies and investors by complementing Corporate Governance Codes applied in a 'comply or explain' context.
- Source of innovation to help guide regulators seeking to establish or update their own stewardship codes. Domestic investors should adhere to national codes before adopting any additional best practices advised by ICGN.

ICGN Global Stewardship Principles

1. Internal governance: foundations of effective stewardship
2. Developing and implementing stewardship policies
3. Monitoring and assessing investee companies
4. Engaging companies and investor collaboration
5. Exercising **and protecting** voting rights
6. Promoting long-term value creation and integration of ESG
7. **Meaningful** transparency, disclosure and reporting

ICGN Global Stewardship Principles

Following the review, some changes are recommended to reflect shifts in market practice and regulation including:

- More emphasis on **fiduciary duty** and the “soft”, but real, issues of **culture and values** by institutional investors.
- An explicit link between fiduciary duty and **long-term value creation**, directly linked to **sustainable benefits for the economy, environment, and society**.
- The use of **ESG factors in investment decision making** and stewardship.
- Greater focus on **systemic risks** relevant to institutional investors.
- More emphasis on the application of stewardship to **asset classes beyond listed equities**.
- Identifying **capital allocation** as an important topic for engagement for both creditors and shareholders.
- **Protecting against the dilution of voting rights** due to dual class shares and other forms of differential ownership which marginalise stewardship and the accountability of companies to minority shareholders.
- Encouraging investors to disclose more **meaningful information about stewardship activities and outcomes**.

The Business Case for Stewardship and Sustainability

Evidence and Business Case: A Critical View

- The anecdotal evidence from recent scandals suggests that very poor corporate governance destroys value, but a general statement is not entirely warranted.
- "Rigorous" empirical research involving econometric models, t statistics, etc. is growing -- but research can be spotty and inconclusive.
- Issues like governance and sustainability are difficult to model and measure.
- Lots of "noise" in the data: what is measurable is not always worth measuring.
- Endogeneity problem: correlations established without causation
  - It suggests that more valuable (better performing) companies also have better corporate governance and sustainability.
  - This does not necessarily prove that improving the corporate governance and sustainability creates value.

Evidence and Business Case: Encouraging Studies

- **Governance**: Nyenrode University/Deloitte (2016) meta study: “Dozens of empirical studies concluded a positive correlation between governance variables and corporate performance, measured in both financial metrics as well as non- financial metrics.”
- **Social responsibility**: Khan, Serafeim, and Yoon (2015): Portfolios weighted for corporate social responsibility factors outperformed by an average return of 3.1% to 8.9% per year over 20+ years.
- **Sustainability**: Clark, Gordon L., Andreas Feiner and Michael Viehs, Oxford University (2014): Metastudy of 200 of the highest quality academic studies and sources on sustainability to assess the economic evidence on both sides for:

Their finding suggest:

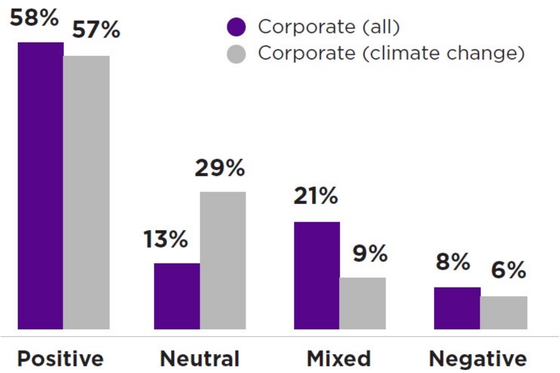
- Companies with strong sustainability scores show better operational performance and are less risky
- Investment strategies that incorporate ESG issues outperform comparable non-ESG strategies
- Active ownership creates value for companies and investors

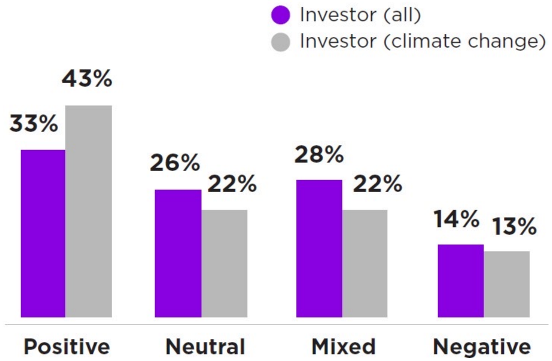
Evidence and Business Case: Latest Meta-Study

- Improved financial performance due to ESG becomes more noticeable over longer time horizons.
- ESG integration as an investment strategy performs better than negative screening.
- ESG investing provides downside protection, especially during a social or economic crisis.
- Sustainability initiatives at corporations appear to drive better financial performance due to mediating factors such as improved risk management and more innovation.
- Studies indicate that managing for a low carbon future improves financial performance.
- ESG disclosure on its own does not drive financial performance.

NYU STERN

ROCKEFELLER ASSET MANAGEMENT



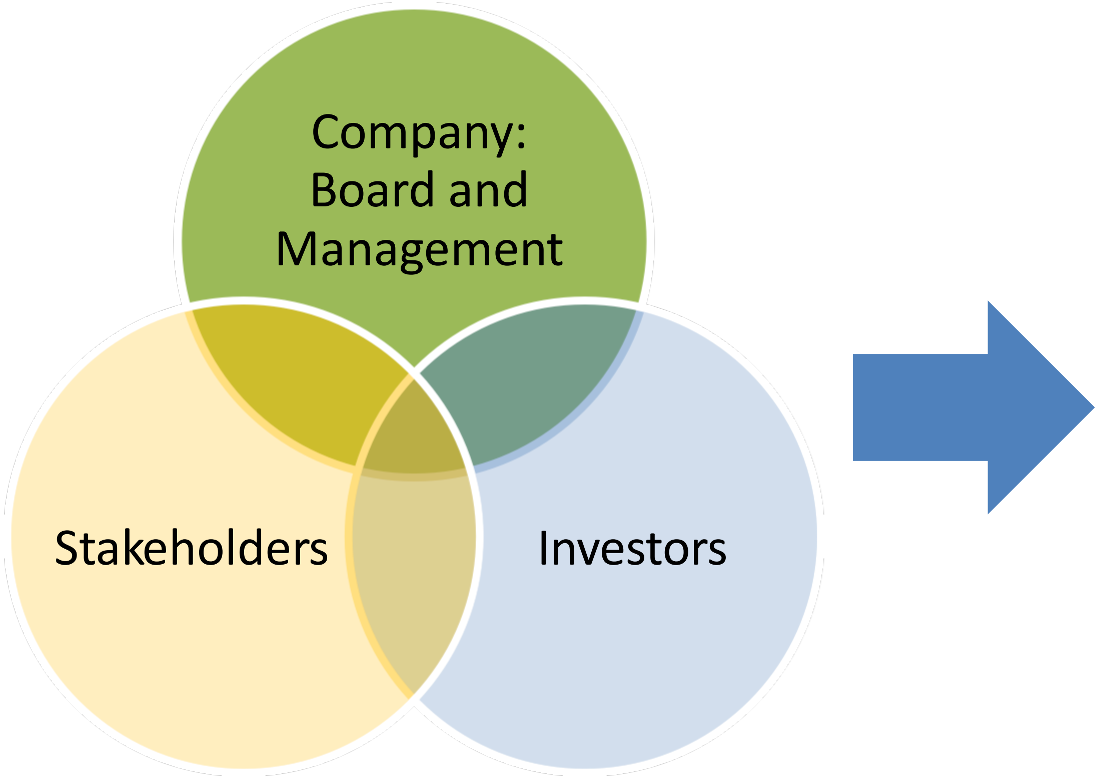


Whelan, T., Atz, U. Van Holt, T. and Clark, C. (2021) 'ESG and Financial Performance: Uncovering the Relationship by Aggregating Evidence from 1,000 Plus Studies Published between 2015 – 2020'

Evidence and Business Case: Less of a Track record than Corporate Governance Research, but Starting to Build

- Engagement on ESG matters improves governance and performance, and encourages a longer-term perspective (Dimson, Karakas and Li, 2018)
- Engagement on ESG matters linked to higher financial returns and better ESG ratings (Barko, Cremers and Renneboog, 2017)
- Engagement can reduce downside risk (Hoepner, et al, 2018)
- Engagement can inhibit entrenchment and pursuit of value destroying M&A activity (Schmidt and Fahlenbrach, 2017)
- Engagement linked to innovative corporate strategies (Aghion, Van Reenen and Zingales, 2013)

Stewardship and Sustainability: Players and Objectives



Micro:
- Company success
- Fair returns for investors
- Stakeholder interests

Macro:
- Sustainable value creation
- Economic growth
- Social welfare

- Theory and Practice of Stewardship and Sustainability
- Corporate Governance and Sustainability
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The Diversity of Corporate Governance Models and Frameworks

Differing Governance Models: Are There "Universal" Principles?

- **Jurisdictional Influences:**
  - Legal structure
  - Ownership patterns
  - State of economic development
  - Development of capital markets
  - Historical, social and cultural norms
- Stage of Company Development:
  - Size
  - Stage of development in the company's life cycle

Overarching **principles** might have more global relevance. OECD CG Principles:

- Fairness
- Responsibility
- Accountability
- Transparency

Rationale for Comply or Explain

- Governance is not “one size fits all”
- Comply or explain linked to Codes as a soft law mechanism: to require explanations when a company does not live up to a code’s provisions
- Flexibility: allows for granular governance practices in governance codes
- without establishing these as inviolable rules.
- Allows for “best practices” even if there is not always clear empirical evidence
- supporting such practices (e.g., split CEO/Chair)

BUT: can it really have “teeth?”

- Requires: monitoring of “explanations” to be effective: regulators, shareholders?
- Relevance in controlled companies?
- Fit in civil law regimes?

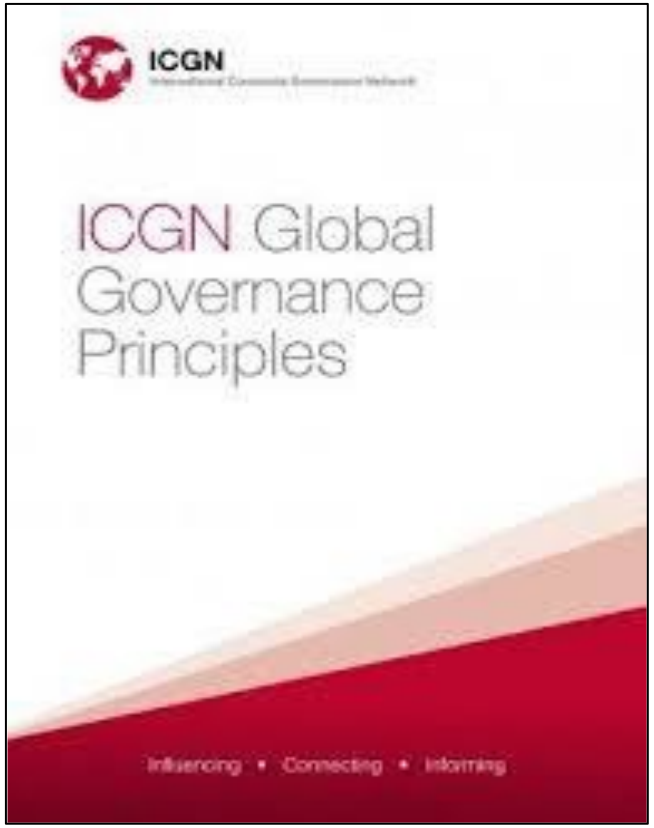
Emerging Markets vs. Developed Markets:
World Bank Governance Indicators 2017/2018

Control of Corruption	Score
United Kingdom	94.7
Germany	94.2
Japan	90.4
United States	88.9
Italy	61.5
South Africa	56.7
India	48.6
China	46.6
Brazil	36.1
Russia	17.3

Rule of Law	Score
United Kingdom	91.8
Germany	91.4
Japan	90.4
United States	89.4
France	88.9
South Korea	86.1
Italy	61.5
India	55.2
South Africa	51.0
Russia	22.1

ICGN Global Governance Principles

1. Global framework: basis of reference
2. Institutional investor perspective and expectations
3. Main focus on listed companies
4. Focus on board composition, structure and effectiveness
5. Board governance responsibilities
6. Recognise that creditors (bond investors) want good corporate governance too



ICGN Global Governance Principles (1/3)

Eight Guiding Principles:

1. Board Role and Responsibilities
   - Focus on long-term success of the company
   - Accountable to investors as providers of risk capital
   - Oversight over mission, purpose, strategy, finance and ESG practices
2. Leadership
   - Balance of roles: split Chair/CEO
   - Majority independence (minimum 1/3 for controlled companies)
3. Board Composition
   - Nomination, skills matrix
   - Board diversity (gender, ethnic, geographic, cognitive)
   - Board evaluations

ICGN Global Governance Principles (2/3)

Eight Guiding Principles:

4. Corporate Culture
   - Ethics, behaviour, conduct
   - Link to strategy, operations, risk management
   - Anticorruption/whistleblowing
5. Risk Oversight
   - Risk culture
   - Comprehensive scope, including material ESG issues
6. Remuneration
   - Align investors and executive management for long-term value creation
   - Independent remuneration committee
   - Board responsible both for structure and reasonableness of quantum

ICGN Global Governance Principles (3/3)

Eight Guiding Principles:

7. Reporting and Audit
   - Auditor oversight and auditor quality
   - Fully independent audit committee
   - Focus on integrated reporting for “non-financial” risks
8. Shareholder Rights
   - Protecting minority shareholders from self-interests of executive management and/or controlling owners
   - Dual class shares
   - Related party transactions
   - Capital allocation
   - Efficient, low cost and accessible voting procedures

ICGN Global Governance Principles 2021 – Key Revisions

- Company purpose
- Director fiduciary duty
- Governance of sustainability
- Stakeholder relations
- Systemic risks
- ESG data and frameworks
- Board diversity
- Board independence
- Capital allocation
- Executive remuneration
- Controlled or group companies
- Shareholder meetings

ICGN Global Governance Principles 2021 – link to revised Global Stewardship Principles

- Seeking ”joined up thinking” between GGP and GSP
- Governance themes embedded in GSP:
  - Identifying capital allocation as an important topic for engagement for both creditors and shareholders.
  - Protecting against the dilution of voting rights due to dual class shares and accountability of companies to minority shareholders.

Corporate Governance as an Ecosystem

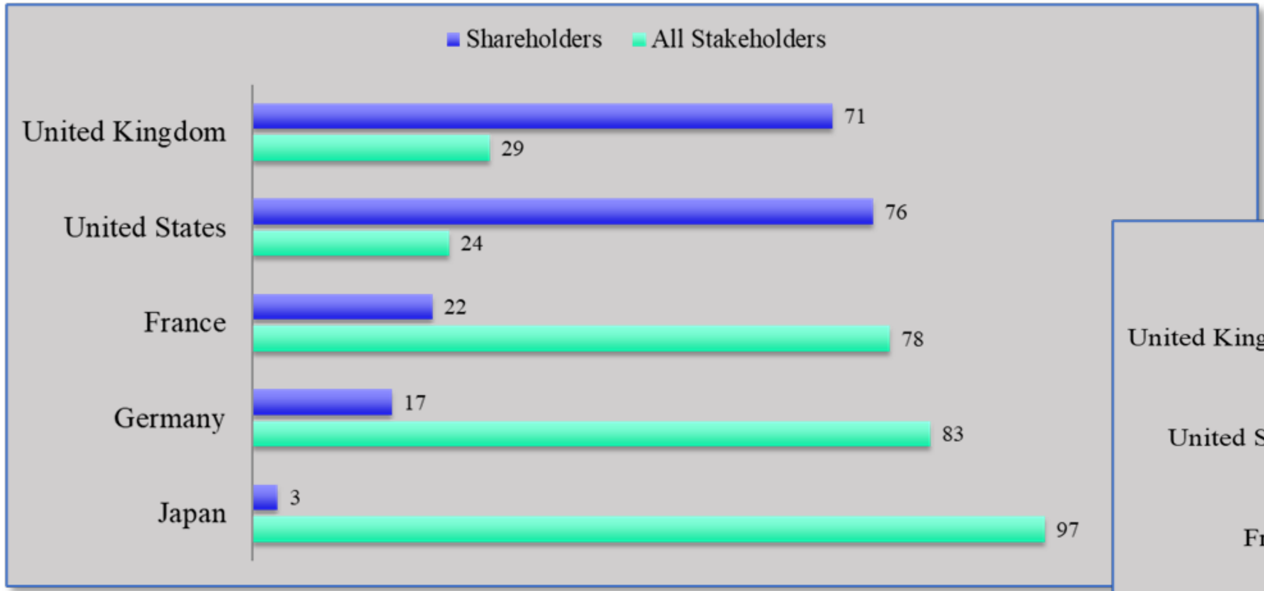
Each Element of Governance has its Own Players

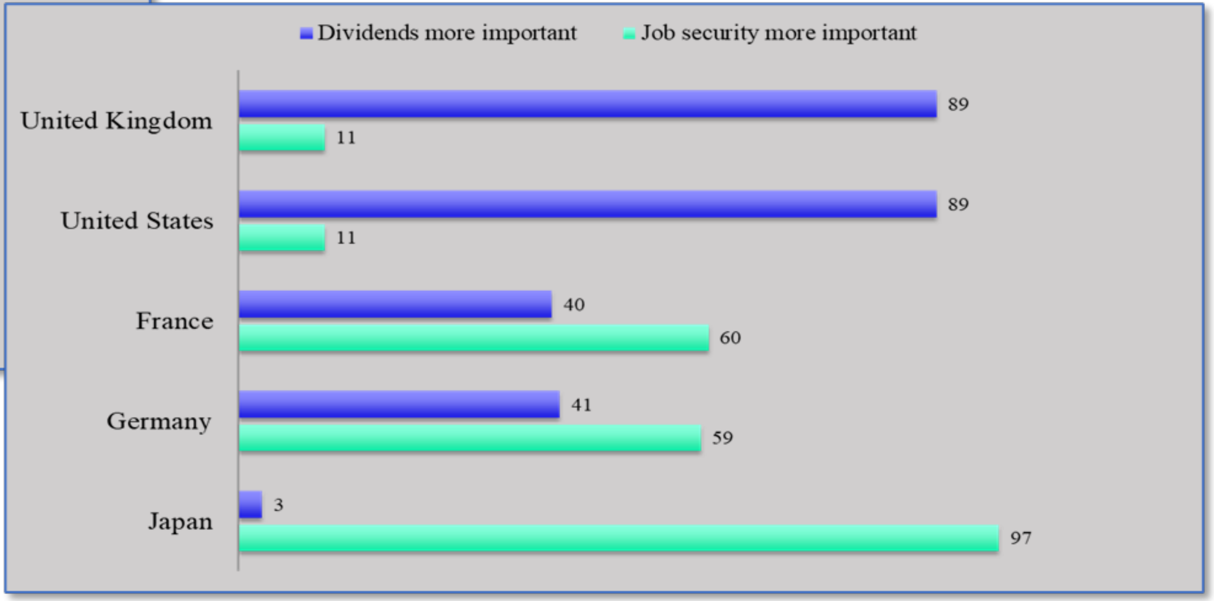
- **Shareholder Rights and Treatment**
  - For Whose Benefit is the Company Run?
- **Boards of Directors**
  - Role, Composition, Organization and Quality
  - Accountability and Incentives
- **Control Environment**
  - Identifying Quantifying and Addressing Risk
  - Internal and External Checks and Balances
- **Transparency and Disclosure**
  - Accounting and Audit Standards
- **Stakeholders**
  - Too numerous to list!
- **Supervision and Enforcement**
  - Public and Private Mechanisms

Corporate Governance Professional

- Company secretaries
- Board advisory services: board evaluations, remuneration, risk management,
- Company advisors: proxy solicitors, governance advisors, engagement advisors
- Institutional investment: buy-side investment analysis (governance as a risk), engagement support and coordination
- Investor services: proxy voting, ESG data and analytics

From the Workbook: Whose company is it? Dividends or Jobs?





Source: Masaru Yoshimori, "Whose Company Is It? The Concept of the Corporation in Japan and the West", Long Range Planning, Vol. 28, No. 4, pp. 33-4, 1995.

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Link Between Governance, Director Duties and Stakeholders

Director duties in the UK: Section 172 of the UK Companies Act (2006)

Duty to promote the success of the company

A director of a company must act in the way he considers, in good faith, would be most likely to **promote the success of the company** **for the benefit of its members (i.e. shareholders)** as a whole, and in doing so have regard (amongst other matters) to:

a) The likely consequences of any decision in the **long term**,

b) the interests of the company's **employees**,

c) the need to foster the company's business relationships with **suppliers, customers and others,**

d) the impact of the company's operations on the **community and the environment**,

e) the desirability of the company maintaining a reputation for **high standards of business conduct**, and

f) the need to act **fairly as between members** (i.e. shareholders) of the company.

Anticipating, Balancing and Managing Conflicts between Stakeholders

Can boards "futureproof" the company from stakeholder risks?

- What are the known and unknown unknowns?
- Where are there "externalities"?
- Sensitivity to stakeholder needs and a strong culture are critical to better understand and anticipate potential social impacts

Corporate Governance and Performance

Governance and Performance: The Evidence

Board Structure Attribute	Findings from Research
Independent chairman	No evidence
Number of outside directors	Mixed
Independent directors	No evidence
Independence of committees	Evidence for audit committee
Bankers on boards	Negative evidence
Accounting experts on boards	Positive evidence
Politically connected directors	No evidence
Employees on boards	Modest evidence
Interlocked boards	Good for performance; bad for monitoring
Busy boards	Negative evidence
Board size	Smaller good (simple cos.), bad (complex cos.)
Female directors	Mixed evidence

Larcker and Tayan, 2021

Academic Evidence and Corporate Governance: A Critical View

- This evidence does not prove **causality**: that is, does not show that good corporate governance **creates** value.
- It shows that more valuable (better) companies **also** have better corporate governance.
- **This does not necessarily mean that improving the corporate governance creates value.**
- The anecdotal evidence from recent scandals suggests that very poor corporate governance destroys value, but a general statement is not entirely warranted.

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- **Managing Stewardship Responsibilities**

Fiduciary Duties

A Primer on Fiduciary Duty

- Fiduciary duty is the duty owed by any skilled person (e.g., a trustee, company director) charged with looking after assets on behalf of another.
- Asset managers owe fiduciary duties to fund investors because they are managing/overseeing/responsible for someone else's money.
- Asset management is a service business
  - ➢ For the client and their ultimate beneficiaries
  - ➢ not for the fund manager
  - ➢ not even for "good" purposes
- Kay Report – "require(s) that the client's interests are put first, that conflict of interest should be avoided, and that the direct and indirect costs of services provided should be reasonable and disclosed."

Fiduciary Duty of Asset Managers

Loyalty

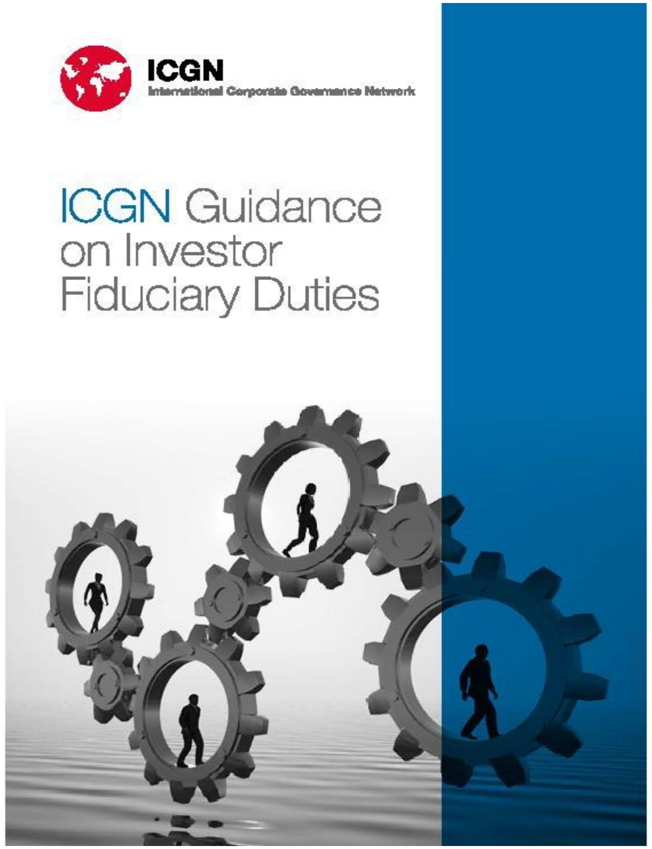
- Actions must be solely in the **interest of beneficiaries**
- Actions must be solely to achieve fund's purpose
- Impartiality between different participant groups, including 'intergenerational
- fairness'
- Avoid conflicts of interest. If conflicts unavoidable:
  - Disclose
  - Manage
  - Minimize and mitigate

Prudence

- Exercise the same **degree of care, skill and caution** as a theoretical reference professional (prudent person/prudent expert, etc.)
- A good heart with an empty head does not meet the standard

ICGN Guidance on Investor Fiduciary Duties (2018)

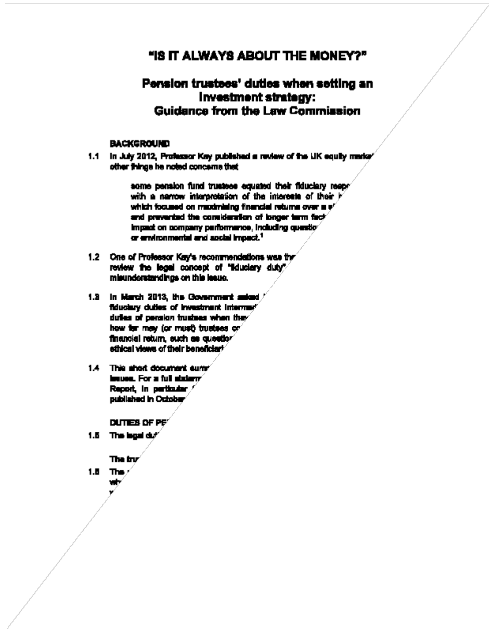
1. Focus on investor duties
2. Investor governance responsibilities
3. Systemic Risk
4. Long-term time horizons
5. ESG factors
6. Fiduciary duty in the investment chain



Academic Evidence and Corporate Governance: A Critical View

When investing in equities over the long-term, the risks will include risks to the long-term sustainability of a company's performance. These may arise from a wide range of factors, including poor governance or environmental degradation, or the risks to a company's reputation arising from the way it treats its customers, suppliers or employees. A company with a poor safety record, or which makes defective products, or which indulges in sharp practices also faces possible risks of legal or regulatory action."

Para 1.16, Guidance on Fiduciary Duty, 2014


"IS IT ALWAYS ABOUT THE MONEY?"

Pension trustees' duties when setting an investment strategy: Guidance from the Law Commission

BACKGROUND

1.1 In July 2012, Professor Kay published a review of the UK equity market ... other things he noted concerns that

some pension fund trustees equated their fiduciary resp... with a narrow interpretation of the interests of their ... which focused on maximising financial returns over a ... and prevented the consideration of longer term fac... impact on company performance, including questio... or environmental and social impact.[1]

1.2 One of Professor Kay's recommendations was th... review the legal concept of "fiduciary duty" ... misunderstandings on this issue.

1.3 In March 2013, the Government asked ... fiduciary duties of investment interme... duties of pension trustees when the... how far may (or must) trustees c... financial return, such as questio... ethical views of their beneficiar...

1.4 This short document sum... issues. For a full statem... Report, in particular ... published in October...

DUTIES OF PE...

1.5 The legal du...

The tru...

1.6 The ...

PERFORMANCE

NOT PHILANTHROPY

European Union Taking the Lead in Sustainable Finance and ESG Integration (1/2)

- **Shareholder Rights Directive**
  - Includes basic stewardship disclosure requirements for investors
- **Capital Markets Union**
- **High Level Expert Group on Sustainable Finance: two imperatives**
  1. *Improve the contribution of finance to sustainable and inclusive growth as well as the mitigation of climate change.*
  2. *Strengthen financial stability by incorporating environmental, social and governance (ESG) factors into investment decision-making. Both imperatives are pressing, given the rising climate-related risks and degradation in the environment and other sustainability areas.*

"Sustainable finance is axiomatically linked to the long term"

European Union Taking the Lead in Sustainable Finance and ESG Integration (2/2)

- **Sustainable corporate governance initiative (2020/21)**
  - Wide ranging review of company law framework
  - Exploring changes in director duties to mandate oversight of stakeholders and supply chains
  - Underlying study by EY severely attacked by academics
- **ICGN Position**
  - Sympathetic with objectives of sustainable corporate governance
  - Share the academics' concerns that the EU is considering far reaching changes to director duties and legal requirements with an insufficient—or at least an unconvincing--basis in evidence
  - EU proposals better suited for comply or explain, soft law mechanisms

United States – Traditional Approach Showing Some Cracks

- **Land of Milton Friedman:**
  "there is one and only one social responsibility of business-- to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud."
- **Corporate responsibility linked to philanthropy**
- **Shareholder primacy**
- **ESG issues:**
  - Traditionally dismissed as "special interests" by social activists who are different from immediate stakeholders
- **Current: Investor bodies (including ICGN) and legal academics petition to the US SEC for ESG disclosure rulemaking**

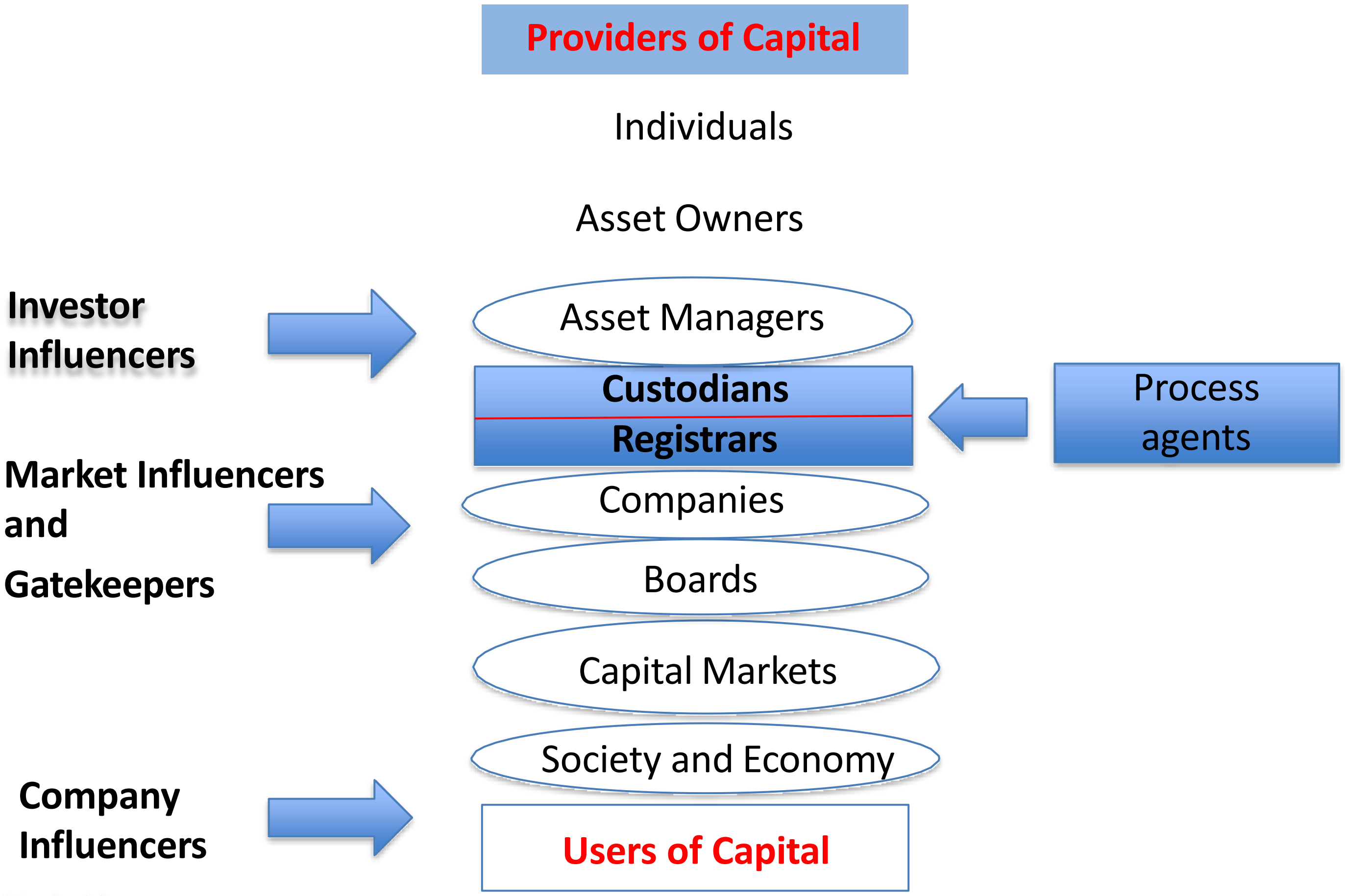
Business Roundtable: Purpose of a corporation is to foster "an economy that serves all Americans"

vs.

Bebchuk: Stakeholderism would increase the insulation of corporate leaders from shareholders, reduce their accountability, and hurt economic performance.

The Investment Chain and the Stewardship Ecosystem

The Asset Chain



Ecosystem of Stewardship: Role of Actors

Asset owners: invest capital to preserve and enhance the value of beneficiaries' assets. They set investment beliefs, allocate assets, award mandates, develop and disclose investment strategies, and monitor and measure performance of asset managers who they incentivise to act on their behalf.

Asset managers: manage assets entrusted to them in alignment with their client's objectives and investment beliefs. They allocate resource, monitor, engage, vote, report to clients and oversee the performance of service providers who act on their behalf.

Companies: issue debt and equity capital in public financial markets to generate sustainable value creation for investors

Service providers: deliver services to enhance the efficiency and quality of stewardship. They offer engagement, vote recommendations and execution, research and data provision, advice, and provision of reporting frameworks.

Ecosystem of Stewardship: Are Investors up to it?

- Do investors have the right skills to provide meaningful company oversight and engagement?
- What decisions are investors well-positioned to take, where does micro-management set in?
- Are investors properly resourced to provide stewardship as part of their asset management responsibility?
- Disconnect between stewardship and modern portfolio theory?
- How do large investors meaningfully monitor, engage and vote equity positions in thousands of holdings?
- Are portfolio managers and governance or ESG specialists operating in silos with different agendas?
- Does the business model of institutional investment need to change for stewardship to be effective? Fewer stock pickers, greater focus on governance and stewardship?
- Are investors too heterogeneous to work collectively?
- Can investor incentive structures and behaviours align with the long-term
- perspectives of beneficiaries?

Investor Governance and Stewardship

ICGN Global Stewardship Principles: Starting point – Investor Governance

Principle 1: Internal governance: foundations of effective stewardship

"Investors should keep under review their own governance practices to ensure consistency with the aims of national requirements and the ICGN Global Stewardship Principles and their ability to serve as fiduciary agents for their beneficiaries or clients."

Focus on Conflicts of Interest: Key Points

- Client/beneficiary interests come first
- Identification of forms of conflicts related to stewardship
- How are conflicts minimized and managed?
- Case studies can make it real and build trust
- Address specific risks:
  - Stock lending
  - Insider information
- Reporting to beneficiaries

ICGN Global Stewardship Principles: Starting point – Investor Governance

Provision	What might it require?	How does your institution measure up?
1.1 Time horizons for delivering value	Alignment with time horizons of beneficiaries: typically LONG TERM	
1.2 Independent oversight	Governance structures that allow for independent review to ensure promotion of client interests	
1.3 Ethics and conduct	Guided by codes of conduct and tone from the top	
1.4 Capacity and experience	Adequate resourcing of stewardship implementation	
1.5 Investment chain	Investors accountable to ensure agents in the chain (including custodians and service providers) are aligned with end beneficiaries	
1.6 Conflicts of interest	Robust policies to minimise or avoid conflicts of interest and such policies should address how matters are handled when the interests of clients or beneficiaries diverge from each other.	
1.7 Appropriate remuneration	How remuneration structures and performance horizons for individual staff members advance alignment with the interests of beneficiaries or clients	

Questions?

Thank you for participating!