FiscalNote | Executive Institute

Sustainability and Social Responsibility

The Emerging Role of Executive Leadership

Why business leaders need to incorporate sustainability into corporate strategies to guarantee their company's long term success

In the past few years, financial and professional (FinPro) liability insurance rates have been increasing globally, driven, in part, by risk exposures of corporate directors and executives. Countries in continental Europe, in particular, have reported drastic increases in FinPro insurance rates, ranging between 5 and 10%[1].

Several factors have been attributed to the EU's growing risk profile, from the enforcement of General Data Protection Regulation (GDPR), to escalating cybersecurity threats[2]. However, while these issues remain listed as major liability concerns for business leaders, there is evidence that suggests that a whole new front of director responsibility is opening up.

Indeed, a recent report from KPMG (Graph 1) notes that CEOs identify Environmental and Climate Change Risk as the number 1 threat to growth, rising four spots from last year[3].

Graph 1: **Threats to Grow**

2019	2018
Environmental/climate change risk	Return to territorialism
Emerging/disruptive technology risk	Cyber-security risk
Return to territorialism	Emerging/disruptive technology risk
Cyber-security risk	Environmental/climate change risk
Operational risk	Operational risk

Source: 2019 Global CEO Outlook, KPMG International

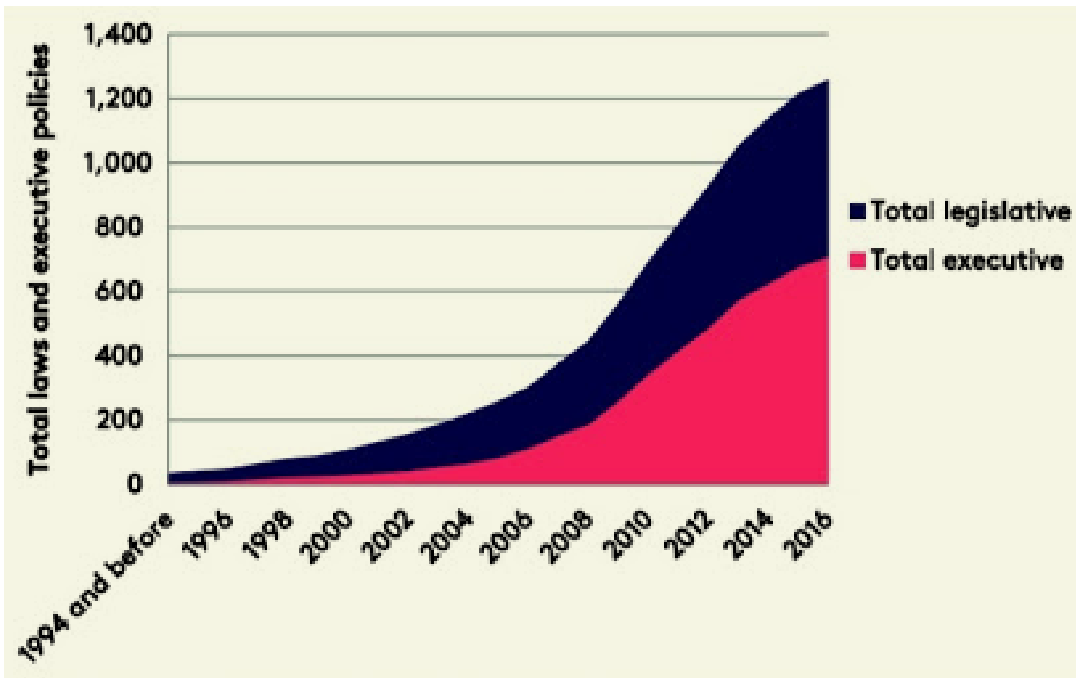
[1] Marsh, Global Insurance Market Index Q1 2019 Report, https://www.marsh.com/uk/insights/research/commercial-insurance-pricing-increased-in-first-quarter-2019.html

[2] "D&O insurance insights - Management liability today: What executives need to know", December 2016, https://www.agcs.allianz.com/news-and-insights/reports/d-o-insurance-insights.html

[3] "KPMG, Agile or Irrelevant - Redefining Resilience", 2019, https://assets.kpmg/content/dam/kpmg/xx/pdf/2019/05/kpmg-global-ceo-outlook-2019.pdf

This trend is emerging for several reasons. Firstly, recent scandals and litigation cases indicate that a company's long-term financial success goes hand-in-hand with its record on environmental, social and corporate responsibility[4]. Secondly, international commitments such as the Paris Climate Agreement and the UN 2030 Agenda for Sustainable Development have resulted the inception of a slew of regulation[5] (Graph 2) giving rise to potential new liability risks.

Graph 2: **Legislative and Executive Acts Up To 2016**



Source:Climate Change Laws of the World

Against this framework, this paper will illustrate how the responsibilities of business leaders are evolving and why they should forge sustainable best practices as a way to guarantee their company's long term potential.

[4] "Sang Jun Cho, Chune Young Chung and Jason Young, Study on the Relationship between CSR and Financial Performance, January 2019

[5] Climate Change Laws of the World database, Grantham Research Institute on Climate Change and the Environment and Sabin Center for Climate Change Law,http://www.lse.ac.uk/GranthamInstitute/legislation/

The Stakeholder Theory

In 1984 the philosopher and business professor R. Edward Freeman wrote *Strategic Management: A Stakeholder Approach* in which he proposed the "stakeholder theory". In this view, shareholders are merely one of the many stakeholders within a company who need to be considered when making decisions. The stakeholder ecosystem comprises anyone involved in, or affected by, the company. Therefore, a business's real success lies in satisfying all its stakeholders, not only the shareholders.

In recent years, company leaders in the United States decided to put themselves at the forefront of the public debate on sustainable development and started embracing this theory.

Larry Fink, CEO of BlackRock, in January 2018 published a letter[6] on the importance for companies, both public and private, to serve a social purpose. "To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society", Fink wrote. According to him, companies that proactively manage the challenges related to their role in society are exposed to fewer risks in the long-term and consequently are more attractive to investors.

In a famous statement[7] published by the Business Roundtable on 19 August 2019, 181 of America's top CEOs committed themselves to making their companies operate for the benefit of all stakeholders. Their objective is no longer solely to maximize returns for their shareholders, but also to "fairly compensate employees", "deal fairly and ethically with suppliers", and "protect the environment by embracing sustainable practices across our businesses".

The reasons why business leaders are embracing this theory are quite straightforward. Firstly, many investors will not invest in a company with poor sustainability performance. According to a recent survey[8] conducted by BCG/MIT, nearly 60% of investment firm board members say they are willing to divest from companies that have poor sustainability performance.

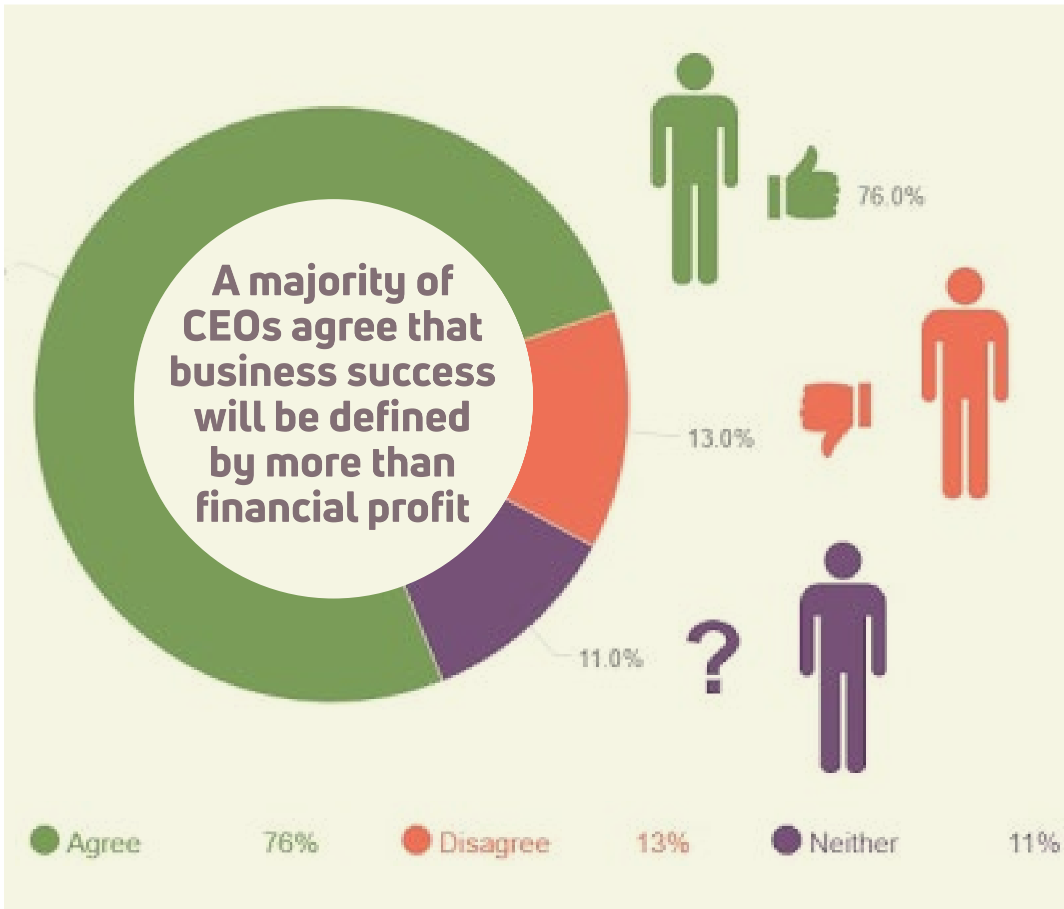
[6] Larry Fink, Annual letter to CEOs, "A Sense of Purpose", January 2018, https://www.blackrock.com/hk/en/insights/larry-fink-ceo-letter

[7] https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans

[8] Boston Consulting Group and MITSloan Management Review, Investing for a Sustainable Future, May 2016, https://sloanreview.mit.edu/projects/investing-for-a-sustainable-future/

Graph 3: **Question**

To what extend do you agree that business success in the 21st century will be refunded by more than financial profit?



Source:PwC's 19th Annual Global CEO Survey

Secondly, legislators are catching up, if they have not done so already. New rules have been adopted, or are in the process of being adopted, with the exact purpose of making corporations more accountable and requiring executives to take sustainability into account.

A Brief Look Around the World

How sustainability is already embedded in the duties of company directors

As a matter of fact, many countries have already started adopting, in one form or another, the "stakeholder" theory into their body of laws.

In South Africa, for example, the King IV Report[9] says that: "directors owe their duties to the company and the company alone as the company is a separate legal entity from the moment it is registered until it is deregistered. However, the company is represented by several interests and these include the interests of shareholders, employees, consumers, the community and the environment. Thus, requiring directors to act in good faith in the interest of 'the company' cannot nowadays mean anything other than a blend of all these interests".

In India, the Companies Act[10] (2013) says that directors should "act in the best interests of the company, its employees, shareholders, the community and for the protection of the environment".

A similar approach was taken by the UK which adopted the 'enlightened shareholder value' model through section 172 of the Companies Act 2006[11]. This requires a director, when taking any decision, to consider: "the interests of the company's employees; the need to foster the company's business relationships; and the impact of the company's operations on the community and the environment".

In France, the government's Action Plan[12] for Business Growth and Transformation suggested that the Civil Code should be amended "to affirm the need for companies to take into consideration social and environmental issues inherent to their activity".

These examples not only show how in many jurisdictions this theory has been taken into consideration and introduced in their legislative framework, but it also shows a shift in thinking, in societal values, in what we can call the "super law", around the world.

With globalisation leading to international regulatory convergence[13], it is not difficult to argue that other countries will soon follow suit. Indeed, the European Union is already in the process of catching up.

[9] Report on Corporate Governance for South Africa 2016, https://www.adams.africa/wp-content/uploads/2016/11/King-IV-Report.pdf

[10] http://mca.gov.in/SearchableActs/Section166.htm

[11] https://www.legislation.gov.uk/ukpga/2006/46/section/172

[12] Action Plan for Business Growth and Transformation, January 2019, https://www.economie.gouv.fr/files/files/2019/DP_PACTE_janvier_2019.pdf

[13] Daniel W. Drezner, Globalization, Harmonization, and Competition: The Different Pathways to Policy Convergence, February 2007

The EU and the Case of Sustainable Finance

Towards a reform of directors' duties to promote sustainability?

The European Commission (the EU's executive body) has also decided to look at the obligations of company directors and will be assessing whether they should be revisited at EU level.

In its Action Plan on Sustainable Finance[14] from March 2018, the European Commission laid out its strategy for a financial system that supports the EU's climate and sustainable development agenda.

Notably, the document includes measures aimed at:

1. Clarifying the duty of asset managers and institutional investors to take sustainability into account in the investment process and enhance disclosure requirements.
2. Incorporating sustainability in prudential requirements.
3. Enhancing transparency in corporate reporting.

Additionally, the Action Plan[15] contains a direct mention to possibly redefine the responsibilities of company directors in relation to sustainability. In particular, the document notes that corporate managers may become overly focused on short-term financial performance and disregard opportunities and risks stemming from environmental and social sustainability considerations. Therefore, it identifies the possible need to clarify the rules according to which directors are expected to act in the company's long-term interest.

This need was initially highlighted by a group of senior experts from civil society, the finance sector and academia in a report[16] published in January 2018. This "High-Level Expert Group on Sustainable Finance" (HLEG) was specifically set up by the Commission with the mission to provide strategic recommendations for a financial system that supports sustainable investments[17].

[14] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52018DC0097

[15] Action 10: Fostering sustainable corporate governance and attenuating short-termism in capital markets, Action Plan on Sustainable Finance

[16] EU High Level Expert Group on Sustainable Finance, "Financing a Sustainable European Economy" Final Report, January 2018, https://ec.europa.eu/info/sites/info/files/180131-sustainable-finance-final-report_en.pdf

[17] https://ec.europa.eu/transparency/regexpert/index.cfm?do=groupDetail.groupDetail&groupID=3485&NewSearch=1&NewSearch=1&Lang=EN

The report argues that for investor stewardship to be effective, it is essential that the consideration of sustainability risks and opportunities becomes an integral part of the way in which the investee companies are governed. Therefore, it proposes that a clear commitment to sustainability is embedded in the duties of company directors and into the governance rules related to company management, supervision and incentive structures.

In its Action Plan the Commission committed to further investigate the issue. EU policy-making is notably slow[18] with new legislation taking up to 6 years before being eventually tabled and adopted. Nevertheless, the report by the HLEG and the Commission's Action Plan clearly shows how environmental and social factors are becoming an increased concern for businesses of all sectors, including the financial sector, and how central the role of directors will be in the future.

Conclusions

With the shifting regulatory environment and the "super law" culture, sustainability is no longer a choice. The urgency of climate change and environmental degradation will irreversibly transform the nature of business and business' responsibilities.

Theories like the "stakeholder" theory are becoming the new "super law", effectively driving policy-makers and business leaders towards embracing sustainability as part of the new status quo.

In order to be best positioned for long-term market success, companies need to welcome sustainability as a business strategy. Corporate leaders need to be aware not just of the stakeholders within their company but also the expectations and actions of wider society.

It is therefore up to them to "future-proof" their operations. Evolving their responsibilities, they must evaluate and acquire the tools and methods to forge sustainable best practices as a way to guarantee their company's long term potential.

[18] Thomas König ,'Convergence or Divergence? From Ever-Growing to EverSlowing European Decision-making Process', 2007

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