ESG in 2020: A Half-Year Review

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Interest in the environmental, social and governance (ESG) policies of companies and their impact on the wider community has continued to increase amongst institutional investors, retail shareholders and the media during the first half of 2020. The COVID-19 pandemic and the Black Lives Matter movement have both resulted in the "S" in ESG becoming rapidly more important as companies seek to reaffirm their public image in response to such events, defying any concerns that ESG issues would fall to the wayside at the onset of an economic crisis. In this article, we review some of the key ESG developments and trends in the UK and Europe in the first half of 2020.

ESG Funds Continue To Grow

At the start of the year, a Morningstar report confirmed that investment pouring into European ESG funds had more than doubled year-on-year — a total of €120 billion in 2019 compared to €48.8 billion in 2018. Many investors historically have shown a reluctance to invest in such funds due to an inability to verify whether they are able to perform as well as (or better than) their non-ESG-focused counterparts. In June, Morningstar released a first-of-its-kind report examining the comparative performance of European ESG funds over one-year, five-year and 10-year periods. The report revealed that close to six out of 10 sustainable funds in fact delivered higher returns than their comparators over the past decade. The last few months have underscored this statistic, with ESG funds reportedly outperforming others in Q1 2020. This is likely due to a combination of their low exposure to oil and gas companies, which have been hard hit by a substantial drop in commodity prices, and high exposure to tech firms, which have weathered the crisis relatively well. Whilst this is encouraging, the report indicates that there are differing levels of success depending on the form of the fund — for example, only three out of 10 ESG euro corporate bond funds achieved better returns than their non-ESG counterparts in the same period. The report also warns that the growing number of ESG funds may lead to potential burn-out in the future as competition increases and the market contracts.

Institutional Investors Voice Their Concerns

Whilst ESG funds continue to make strides, institutional investors also have continued to push their own ESG agendas directly. The chief executive of BNP Paribas Asset Management stated in a recent *Financial Times* article that the firm has "put sustainable investing at the very heart" of its strategy, and it was ranked among the best asset managers in the world for ESG in an April report by ShareAction, the responsible investment organisation. Other institutional investors such as Legal & General Investment Management and DWS Group have received positive coverage and recognition for their willingness to vote against directors over climate issues. In the broader activist market, an initial hiatus in activity due to caution about investing during the COVID-19 pandemic appears to be coming to an end. In particular, as the UK stock market has not rebounded as quickly as those in the U.S., activists may seek to gain ground in the second half of 2020 and use this as an opportunity to relaunch ESG-related campaigns focused on companies' governance, decision-making and social policies during the crisis.

In January, the new UK Stewardship Code 2020 came into force, having received a "substantial and ambitious" revision. The Financial Reporting Council has redefined the meaning of stewardship as "*the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society*". The Stewardship Code now requires asset managers and investors to place a greater focus on ESG matters and requires signatories to produce an annual stewardship report explaining how they have applied the Stewardship Code in the previous 12 months.

The 'S' in ESG Begins To Shine

In the past few years, the "E" and "G" of ESG have received most of the attention, with shareholders focused on concerns such as director remuneration and climate change-friendly policies. The "S" often has struggled to gain substantive traction, partly due to the difficulty in quantifying such concerns and the lack of available data. However, the pandemic has brought much needed attention to the "S" — in particular, in relation to the treatment of workers by their employers. Previously, social policies have tended to focus on issues that can be measured, such as gender discrimination (equal pay and board diversity) and social outreach, but in light of COVID-19 and the Black Lives Matter movement, social issues have received increased attention and companies are expanding their policies to cover broader issues, such as employee welfare and company culture. Recent events also have renewed the spotlight on racial diversity at the board level and in management teams.

In April, Legal & General Investment Management urged companies to treat their staff well during the pandemic or risk facing the consequences. There also has been increasing pressure on companies to do so due to the attention given to these concerns by the media. For instance, in the early stages of lockdown in the UK, J D Wetherspoon, the pub chain, stated that they would not pay their staff during lockdown because they could go and find alternative jobs in supermarkets. A public backlash and an open letter from MPs preceded the chairman reversing the company's position. Similarly, Sports Direct faced public criticism after trying to keep their stores open in contravention of government orders, putting their employees at risk.

Such concerns are not solely linked to issues arising during the pandemic. In July, following an article about a *Sunday Times* investigation, Standard Life Aberdeen sold its shareholding in Boohoo, a UK online fashion retailer, as a result of claims regarding the poor working conditions at its suppliers described in the article. It was by no means the only sustainable fund invested in Boohoo as 20 others were highlighted as shareholders by Morningstar, and other ESG risks in supply chains (such as environmental pollution, workforce health and safety incidents and labour disputes) continue to receive increased interest. This example shows that the spotlight of publicity can lead to swift decision-making by institutional investors.

The World Queries the Purpose of the Modern Company

In addition to institutional investor attention, there has also been a wider movement to begin to reconsider the purpose of the modern company. Under the UK's revised Corporate Governance Code 2018, the board of a premium-listed company is now required to "*establish the company's purpose, values and strategy, and satisfy itself that these and its culture are aligned*". Directors also are now required to demonstrate how they have discharged their duties under Section 172 of the Companies Act 2006 by including a statement in the company's annual report. These duties go beyond solely creating value for shareholders in the long-term and require directors to take into consideration a broader spectrum of factors, including ESG concerns such as the interests of the company's employees and the impact of the company's operations on the community and environment. The majority of companies have satisfied their obligations by including a one-page statement identifying their key stakeholders and summarising how they have engaged with them throughout the year, before referring to other sections of the annual report for further details and examples. A few companies have gone a step further and provided specific "in-depth case studies" to demonstrate how they have taken stakeholder concerns into account in implementing their strategy and any progress made throughout the past year.

Beyond the UK, the number of companies seeking the B Corporation certification — a private certification for businesses that balance purpose and profit issued by the US non-profit organisation, B Lab — continues to increase. Most B Corps are small to medium private companies based in the US; however, a number of larger companies from across the globe are now targeting the certification. In early July, Lemonade — a SoftBank-backed insurance start-up — completed its IPO as a B Corp, only the fifth US company to do so (although other such companies have been forced to let their certification lapse post-IPO in order to maintain their corporate structure). The performance of these companies is likely to be closely watched by Wall Street and other companies to determine the viability of such a move and the perceived marketing benefits during the IPO process.

France has taken this concept a step further, introducing last year the ability for any company to specify its principles and social purposes in its articles of association (*raison d'être*) and a new legal status for companies: an *enterprise à mission* ("purpose-driven company"). Several French listed companies (including Veolia, Engie and BNP Paribas) have included a *raison d'être* in their articles, allowing them to publicly define the undertakings and values that guide their strategy and to which internal resources should be applied. Adopting the status of a purpose-driven company is more binding, as it entails a declaration to the commercial court, the implementation of a supervisory committee to monitor the company's pursuit of its social and environmental targets, and the verification of such targets by an independent third party. In June, the shareholders of Danone voted to enshrine their "health through food" mission, becoming the first large listed company to adopt the new legal status. From now on, Danone will not only have to generate profit for its shareholders but do so in a way that will benefit its customers' and the planet's health. Whether more public companies will adopt this status in France or seek B Corp certification this year may depend on the performance of companies like Lemonade and Danone as others use the next 12 months as a form of litmus test.

The LSE Makes Its Green Economy Mark

The London Stock Exchange (LSE) also has launched a new classification for issuers to help investors solve the challenge of identifying green economy equities to enable diverse exposure rather than limiting investors to a narrow scope of industries. Introduced in October 2019, the Green Economy Mark — a world-first, data-driven, green classification for equity issuers — identifies companies across all segments of the Main Market and AIM, a market of the LSE, with at least 50% of their total revenues derived from green products and services. Although the Mark has been given mainly to existing listed companies, Calisen became the first company to qualify for the Mark at admission in February, which the company said was beneficial in pre-IPO conversations with investors and may lead the way for other IPO candidates. As of 29 June 2020, the Green Economy Mark is now held by 86 issuers with a combined market capitalisation of over £67 billion, including mainstream industrial companies such as Johnson Matthey plc, Smurfit Kappa Group plc and SIG plc. Although this represents a small portion of the total market, it is a positive start for the new classification and underlines the LSE's commitment to supporting sustainable finance and investment.

The EU Moves Its Sustainable Legislation Agenda Forward

In recognition of the Paris Agreement and the EU's pledge to be carbon neutral by 2050, the EU has slated a framework of regulations intended to facilitate this goal. The Taxonomy Regulation, which came into force this month, establishes an EU-wide environmental classification framework to enable financial market participants to identify which economic activities are environmentally sustainable. The provisions of the Sustainability-Related Disclosure Regulation will apply from March 2021 and will require companies to implement policies and make certain disclosures to investors as to how ESG factors are being integrated into investment decisions and internal processes. Finally, the European Commission's ongoing review, and subsequent amendment, of the Non-Financial Reporting Directive will provide further direction to ensure that reliable, comparable and relevant ESG information can be disclosed by issuers. The EU generally is seen as moving ahead of the rest of the world in enacting this type of legislation to help classify ESG; in the US, the SEC has hesitated to standardise ESG disclosure, relying instead on the "marketplace evolution of sustainability disclosures".

The UK Treasury stated in a May letter to the House of Commons that it is reserving judgement on whether to onshore the Taxonomy Regulation. Although the EU and UK are aligned on the need for a global standard to prevent "greenwashing",[1] the Treasury considers that the lack of technical detail in the regulation and reliance on future EU delegated acts means that it does not wish to commit to implementation before receiving more detail on what the regulation will require. This has created uncertainty for global asset managers, as not adopting the Taxonomy Regulation in the UK could result in competing regulatory regimes, which would be further complicated if the SEC subsequently introduces its own classification system. Despite the potential for a disparity in the levels of regulatory oversight across different jurisdictions, the growth of ESG funds is likely to lead to enhanced regulatory scrutiny of funds labelled as being compliant with ESG standards.

Looking Forward

Although many ESG policies aim to effect changes over the course of years and decades, the first half of 2020 has demonstrated that the focus on ESG issues can be rapidly catalysed by global events and movements. As the UK and European economy moves into the next stage of recovery from the COVID-19 pandemic, investors may start to look back at companies' performance during the earlier stages of the crisis and seek to hold management to account for any actions considered incompatible with ESG principles. There also may be renewed engagement from investors and activists encouraging companies to recover from the crisis in a sustainable way. Finally, the phased implementation of the EU's new sustainability legislation over the following months and years (and any regulatory divergence in the UK as a result of Brexit) will bring a new classification system and disclosure regime that companies will need to adopt, understand and respond to.

[1] "Greenwashing" is the process of conveying a false impression or providing misleading information about how a company's products are more environmentally sound.

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