No room for bad behaviour

Christopher Alkan assesses whether making companies improve ESG business practices is best left to market forces or to government action through regulation

Forcing companies to behave ethically could become increasingly unnecessary, Mark Carney, the former Bank of England governor, appeared to suggest in a recent speech on climate change. On the issue of emissions, he argued: "Corporates and the financial sector have jumped ahead of government." His point could equally well apply to a broader range of environmental, social and governance issues. If companies are already trying to prevent being penalised by consumers and investors for ESG lapses, strict government regulation to boost ESG business practices may be pointless – or even harmful. In other words, the market has the issue covered.

But there is also plenty of opposition to the idea that market forces alone are sufficient to police corporate behaviour. For example, the Swiss Coalition for Corporate Justice – led by 120 NGOs, including churches – wants to make the nation's businesses legally liable for ecological or human rights violations anywhere in the world. There is likely to be a referendum on the proposal in November.

> *There is a greater commercial downside for companies that are found to be damaging the environment*

Proponents of the measure argue that it will force multinational companies to show greater diligence in ensuring subsidiaries and suppliers avoid harm to the societies in which they operate. "There has been a groundswell of opinion in Switzerland that the multinationals based in the country need to be held to the highest standards of ethical conduct," says Mark Pieth, a legal professor at the University of Basel and founder of the Basel Institute on Governance. "The advantage of this approach is that while the legal systems of many developing nations can be open to manipulation by powerful companies, the Swiss legal system is less vulnerable to abuse."

But those who oppose the move have a counter-proposal that could quickly be put into law. The Swiss National Parliament agreed on 5 June to support new duties of care but to draw the line at liability – which suggests that any final regulations may not be as onerous as campaigners would like.

One often-cited argument against stringent measures is that Switzerland would become less attractive to major companies because they can easily move to jurisdictions that do not hold them to such high standards. But that may not be the case. The US Supreme Court, for example, is set to rule on whether US companies can be sued in US courts for human rights violations that took place abroad. That follows an appeal by Cargill, the food group, and a Nestlé subsidiary, which have both been accused of helping perpetuate slavery at Ivory Coast cocoa farms.

So, will the charge be led by governments and the courts, in what could be seen as highly politicised and potentially divisive decisions, or by market forces, which lack democratic accountability but claim to take objective decisions based on what will make for the best overall returns?

Advocates for the market-driven approach make some persuasive points. For instance, the financial incentives for strong ESG performance have been increasing, which means companies should push it harder. "There is a greater commercial downside for companies that are found to be damaging the environment or harming their workers," says William Paddock, co-founder and managing director of WAP Sustainability Consulting.

The risk goes beyond being shunned by consumers. Investors are increasingly incorporating ESG standards into the way they select securities. Asset managers can now draw on detailed assessments from ESG rating providers, including MSCI, Sustainalytics, Video Eiris, Asset4 and RobecoSAM.

Consumer and investor scrutiny does have an impact on business strategy and many companies accused of ESG breaches have been working hard to improve their performance. Diversified miner Glencore, for example, now runs training courses for key staff on managing risks to human rights through its supply chain. "Our new approach has raised awareness of the importance of tracking, investigating and managing social and human rights incidents," says Anna Krutikov, the company's head of sustainability.

But a purely market-based approach has its drawbacks. For instance, the methodology for assessing how well companies are doing is still in its infancy – making it complicated for investors to discover what companies are really doing; to compare like with like; and to hold executives fully to account.

This was underlined by a recent study by the Massachusetts Institute of Technology (MIT), which found a striking level of disagreement between the five most prominent companies (MSCI, Sustainalytics, Video Eiris, Asset4 and RobecoSAM).

"On the issue of emissions, for example, the correlation between ratings was just 0.13, on a scale of zero to 1," says Florian Berg, a post-doctoral associate at the MIT's Sloan School of Management and co-author of the report 'Aggregate Confusion: the divergence of ESG ratings'. For comparison, the correlation between credit ratings for companies provided by Moody's and Standard & Poor's is 0.99. "It's pretty hard to reward the virtuous and shun ESG laggards if investors can't agree which is which," Berg argues. Ensuring common standards of ESG reporting, even within the same industry, is likely to be a painstaking process.

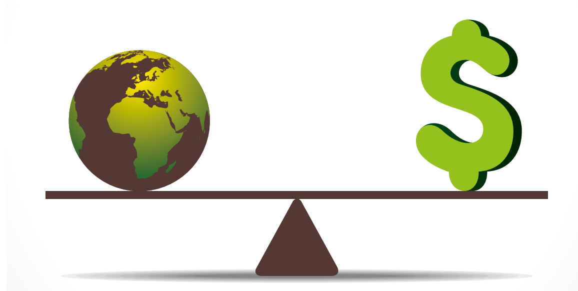
Despite the growing amount of lip service being paid to ESG, research continues to uncover widespread abuse – and often in unexpected quarters. A report published in June this year by the Business & Human Rights Resource Centre found that renewable energy companies – typically assumed to be paragons of corporate responsibility – were routinely failing to protect the rights of workers in their mineral supply chains. The research found that most clean energy companies analysed lack essential policies and practices to avert, identify and remedy human rights abuses, with hundreds of cases –including killings, threats and land seizures – identified over the past decade.

> *Most clean energy companies lacked policies and practices to avert, identify and remedy human rights abuses*

Mary Robinson, adjunct professor for climate justice at Trinity College Dublin and former president of Ireland, said that "a net-zero carbon future can and must go hand in hand with sustainable development, poverty reduction and reducing inequality", implying that this was not the case at present. Research indicated that nearly half of the renewable energy companies surveyed scored below 10% on respecting human rights, with three-quarters receiving ratings below 40%.

Why governmental clout matters

More broadly, Rosey Hurst, founder and director of Impactt, an ethical corporate consultancy, believes certain corporate abuses – notably forced labour – have actually been rising in



prevalence over recent years. "This seems to be being driven by pressure on companies to meet earnings forecasts and due to a growing number of people seeking opportunities out of their home countries," she argues.

The International Labour Organization estimates that around 25m people are trapped in forced labour. Hurst believes even this shocking figure understates the problem. "Government regulations and legal pressure in rich countries are needed to make up for the weakness of regulation in many developing countries," she says.

Many experts argue that government regulations, backed by the threat of legal action, are an indispensable driver behind ESG progress. "Part of the reason investors have made ESG such a focus is because of the expectation of ever-tighter regulation from governments," says Axel Pierron, co-founder and managing director of Opimas, a capital markets management consultancy that advises global financial services firms.

"ESG performance is often a good indicator of management quality in general," he says. "But a company with a poor record on ESG is more likely to be penalised by regulation or face lawsuits. If such threats recede, or disappear, there is less reason to expect a difference in risk or financial performance between companies with strong and weak ESG scores. We really need pressure on all fronts – consumers, investors, businesses and certainly governments."

Pieth also makes the case that strict controls on corporate behaviour via regulators and the courts will always be necessary to establish minimum standards. "Top-tier companies have an interest in this, since it reduces the potential for being undercut by less scrupulous rivals," he says.

There will always be bad actors who need to be restrained. "Although most people would not commit theft or murder even if it were legal, it doesn't mean the law isn't needed," Peith argues. "The same is true for companies." ■

Christopher Alkan *has spent the past three decades working as a financial journalist and in financial institutions*