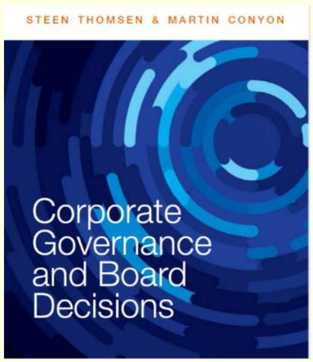
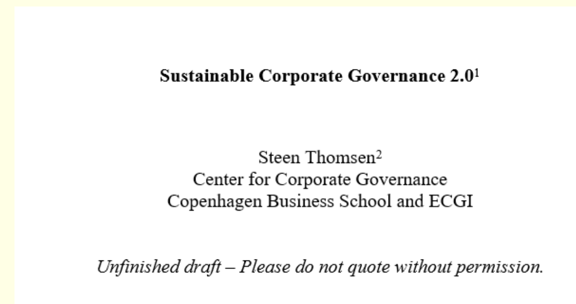
Sustainable Corporate Governance




Sustainable Corporate Governance 2.0[1]

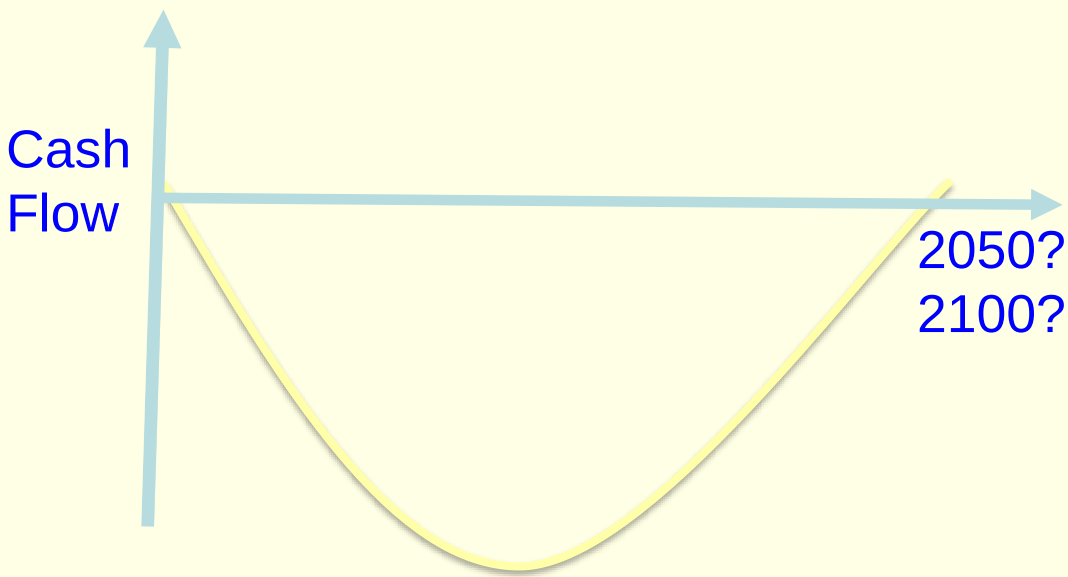
Steen Thomsen[2]
Center for Corporate Governance
Copenhagen Business School and ECGI

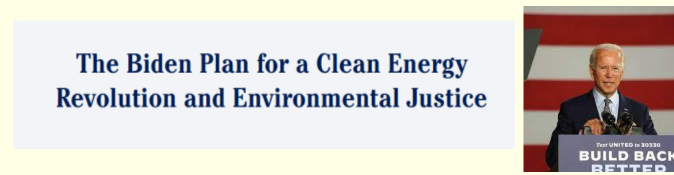
Unfinished draft – Please do not quote without permission.

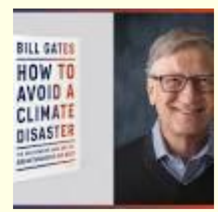
Steen Thomsen
st.ccg@cbs.dk
Center for Corporate Governance
Copenhagen Business School
http://uk.cbs.dk/ccg

Green Transition to net zero

- Sustainable business
- Sustainable finance
- Sustainability reporting
- Supply chain due diligence
- Sustainable governance…?







Global Investment 2023-2050
4-6 trillion $ a year?
4-6% of global GDP?

Green transition
5 assumptions

- We have to get to net zero CO2 emissions to stabilize the climate
- It's a massive challenge, 10xCorona
- It's not just climate
- Governments will do too little, too late
- The climate will change and business will be blamed

Definining Sustainabílity

- The UN Brundtland Commission *"meeting the needs of the present without compromising the ability of future generations to meet their own needs."*
- The 17 UN Sustainable Development Goals

What about Corporate Governance?

Sustainable Corporate Governance?

Regulation	Carbon Taxes etc Governance Rules
Ownership	Purpose Long-term ownership ESG Investment
Boards	Sustainability Committees Sustainability Competencies
Management	ESG Incentives Climate Plans Climate risk management
Operations	Sustainability reports Internal Carbon Pricing

Company Purpose

Company Purpose

- Companies articulate a purpose
- A ”raison d’etre” (reason to be)
- stating how the company contributes to society

IKEA

- “At IKEA our vision is to create a better everyday life for the many people. Our business idea supports this vision by offering a wide range of well-designed, functional home furnishing products at prices so low that as many people as possible will be able to afford them.”

More examples

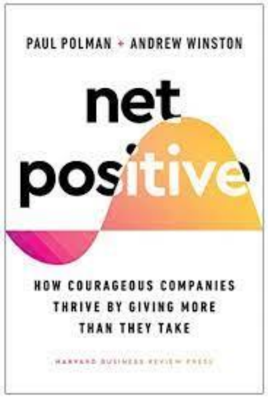
- P. Møller Mærsk…to maximise shareholder value, while delivering on our purpose of enabling cost competitive, simple and sustainable global trade
- Carlsberg: …Brewing for a better today & tomorrow… We strive to brew better beers…attractive by delivering value for shareholders, employees, and society.
- Electrolux: We reinvent taste, care and wellbeing experiences for more enjoyable and sustainable living around the world .. The vision of Electrolux is to become the best appliance company in the world as measured by customers, employees and shareholders. The financial goals set by Electrolux aim to strengthen the Group's leading, global position in the industry and assist in generating a healthy total return for Electrolux shareholders.
- Google's corporate mission is "to organize the world's information and make it universally accessible and useful." Ever since its beginnings, the company has focused on developing its proprietary algorithms to maximize effectiveness in organizing online information.
- Aramco .. We're a leading producer of the energy and chemicals that drive global commerce and enhance the daily lives of people around the globe…long term vision of becoming the world's leading energy and chemical enterprise. This includes prudently managing the Kingdom's hydrocarbon resources, adding value across the value chain, reliably meeting its customers' demand, and meeting its stakeholder and environmental commitments.
- Pfizer inc.: Breakthroughs that change patients' lives..working together for a healthier world..At Pfizer, we apply science and our global resources to bring therapies to people that extend and significantly improve their lives. We strive to set the standard for quality, safety and value in the discovery, development and manufacture of health care products, including innovative medicines and vaccines.
- Unilever.. Our purpose is to make sustainable living commonplace. To realise our vision we have invested in a long-term strategy of divisions and brands that deliver growth to the benefit of all stakeholders. Growing the business…Improving health and well-being ...Nutrition: Health and hygiene. Enhancing livelihoods. Fairness in the workplace..Opportunities for women..Inclusive business…Reducing environmental impact: Greenhouses gases, Water Waste, Sustainable sourcing
- Philips: Our purpose is to make the world healthier and more sustainable through innovation. Our goal is to improve the lives of 3 billion people a year by 2030. We will be the best place to work for people who share our passion. Together we will deliver superior value for our customers and shareholders. Today, Philips is a leading health technology company focused on improving people's health and enabling better outcomes across the health continuum – thereby creating value for its stakeholders.

Corporate Purpose

Purpose Statements Eurostox 600	Total
No	239
%	58.6%
Yes	169
%	41.4%
Total	408
%	100.0

Purpose Visíon/Mission category	Total
Customers	110
%	26.9
Product+	77
%	18.9
Sustainability	66
%	16.2
Product	55
%	13.7
Slogan	42
%	10.3
No. 1	37
%	9.1
None	21
%	5.2
Total	408
%	100.0

Company Purpose Evolves



- Purpose 1.0
  "The purpose is the product"
- Purpose 2.0
  "The purpose is to create value for costumers"
- Purpose 3.0
  "The purpose is to create value for society in general through our business while ensuring a net positive contribution to all stakeholders and the environment"
- => Value creation net of private and social cost

Problems with Purpose

- Commitment (hot air?)
- Governance

- => A meaningful purpose must be rooted in ownership, board, management…

Ownership

Ownership and Time Horizons

Short < 2 years | Medium ≈ 5 years | Long > 10 years

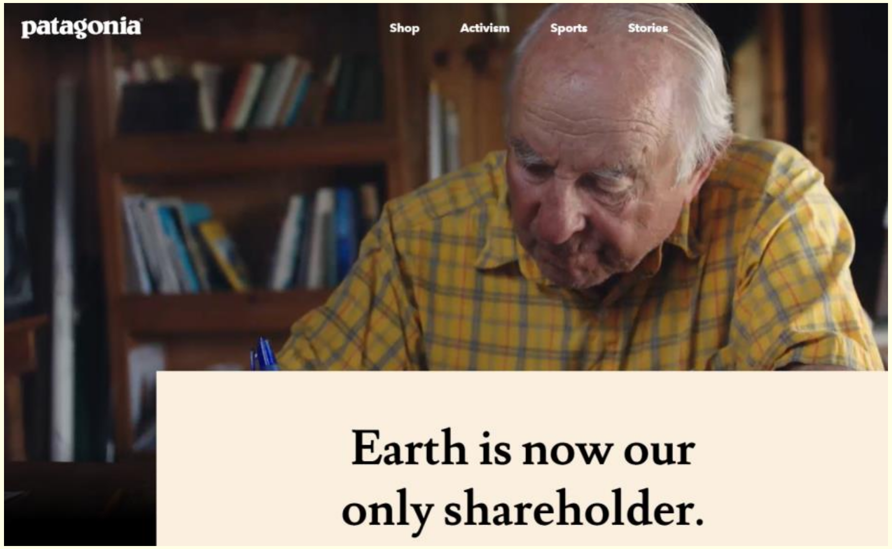
Financial Investors
- Hedge funds
- Asset managers
- Private Investors
- High-Frequency traders

Strategic Shareholders
- Private equity
- Institutional investors
- …

Long-Term Owners
- Founders
- Families
- Foundations
- Coops/mutuals
- …….

Agency

Stewardship



Corporate Sustainability Leadership? Nordics and California

UC Berkeley, 21-22 March 2019

3.45-5.15 pm: SESSION 4

Exercising the freedom to be Responsible: First steps toward saving the planet
Vincent Stanley, Patagonia

Foundation Ownership at IKEA
Steen Thomsen

Patagonia as an Industrial Foundation: A Thought Exercise
Robert Strand (presenting author) and Steen Thomsen

Yvon Chouinard has divested control over Patagonia to a trust and future profits to a nonprofit. Whereas trust-controlled firms are new to the US, a similar corporate governance form has been around for centuries in Scandinavian countries. Their foundation-owned firms have been highly successful, survived for generations, and contributed to a better world.

Berkeley Haas Case Series

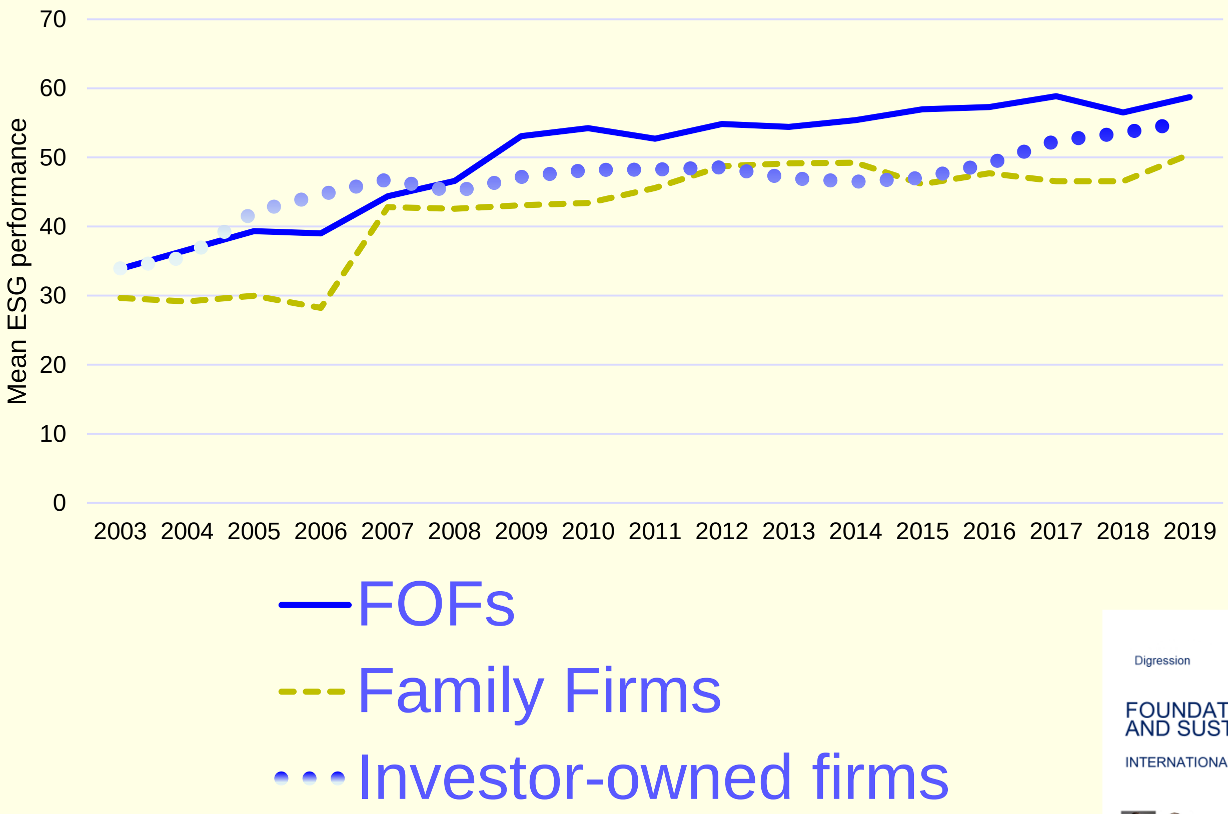
Date: April 2021

LAURA TYSON
STEEN THOMSEN
ROBERT STRAND
EMILY PELISSIER
EVA GURFEIN

Perpetual Purpose Trust and Organically Grown Company: Rethinking Corporate Ownership for the Future

Forbes

Sustainability – ESG ratings



What about other owners?

Received: 27 February 2021 | Revised: 12 July 2022 | Accepted: 14 July 2022
DOI: 10.1111/corg.12486

REVIEW ARTICLE

WILEY

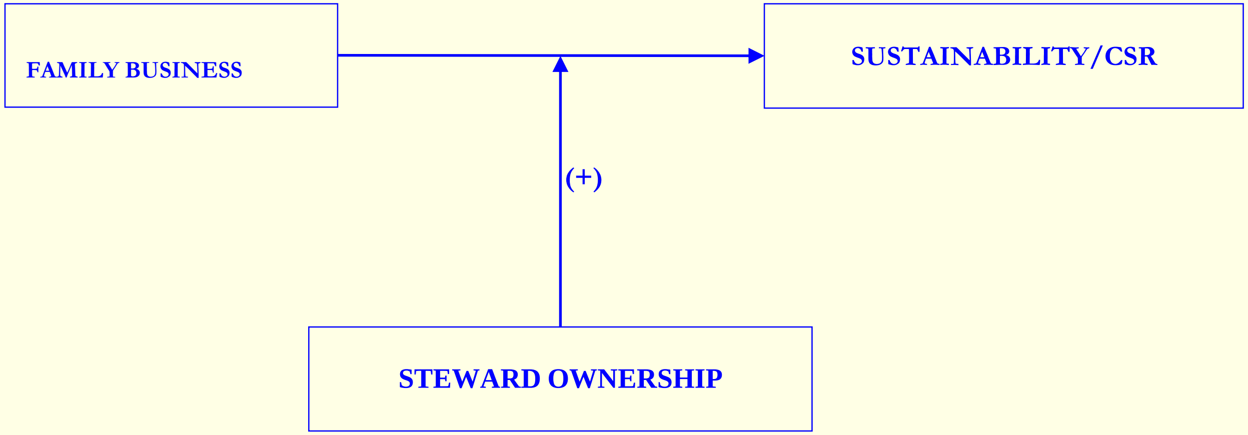
Sustainable corporate governance: A review of research on long-term corporate ownership and sustainability

Nikolaos Kavadis[1] | Steen Thomsen[2]

Sustainability Impact

	Number of Articles		
Owner type	**Positive**	**Negative**	**NS**
Institutional investors (long-term institutional investors)	43 (9)	11 (1)	12 (0)
State	25	7	8
Foreign	20	0	6
Family	17	13	2
Insider	7	6	9
Ownership concentration	5	6	2

The emerging picture



ESG Investment

Sustainable investment (ESG Investment)

- Sustainable Investment is growing fast worldwide 12.9%/year (PWC 2022)
- It now accounts for 1/3 of invested assets in the US (Berg et al. 2021) and 21.5% globally by 2026 (PWC 2022)
- Why is this happening?

The New Corporate Governance

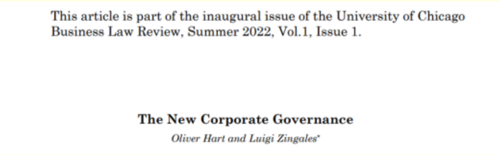
This article is part of the inaugural issue of the University of Chicago Business Law Review, Summer 2022, Vol.1, Issue 1.

The New Corporate Governance

*Oliver Hart and Luigi Zingales**

Argument

- Shareholder value maximization is inconsistent with the common good (social welfare) when there are important externalities (e.g. CO_2 emissions and climate change) that are not addressed by government
- Universal owners like Blackrock with very diversified global portfolios "own the world" and are "owned by the world" (because of their global clients). They will rationally take externalities into consideration (e.g. climate, ESG).
- They pursue "shareholder welfare maximization" rather than "shareholder value maximization"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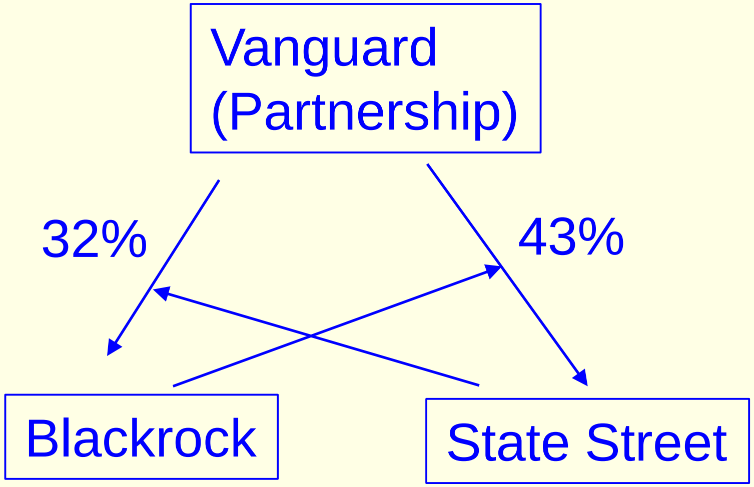
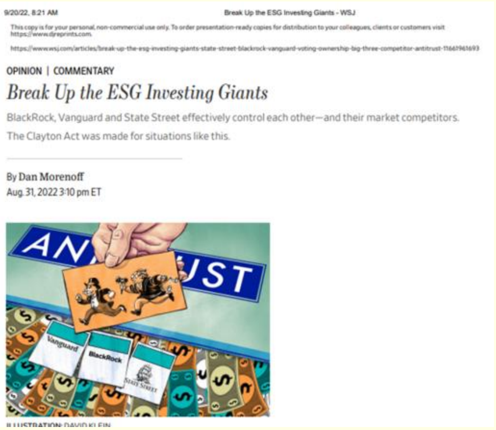
The New Corporate Governance

*Oliver Hart and Luigi Zingales**

Big 3 ownership ties





9/20/22, 8:21 AM Break Up the ESG Investing Giants - WSJ

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https://www.wsj.com/articles/break-up-the-esg-investing-giants-state-street-blackrock-vanguard-voting-ownership-big-three-competitor-antitrust-11661961693

OPINION | COMMENTARY

Break Up the ESG Investing Giants

BlackRock, Vanguard and State Street effectively control each other—and their market competitors. The Clayton Act was made for situations like this.

By Dan Morenoff
Aug. 31, 2022 3:10 pm ET

The Big 3 are not owned by the world and have serious accountability issues

ESG Ratings

ESG Origins

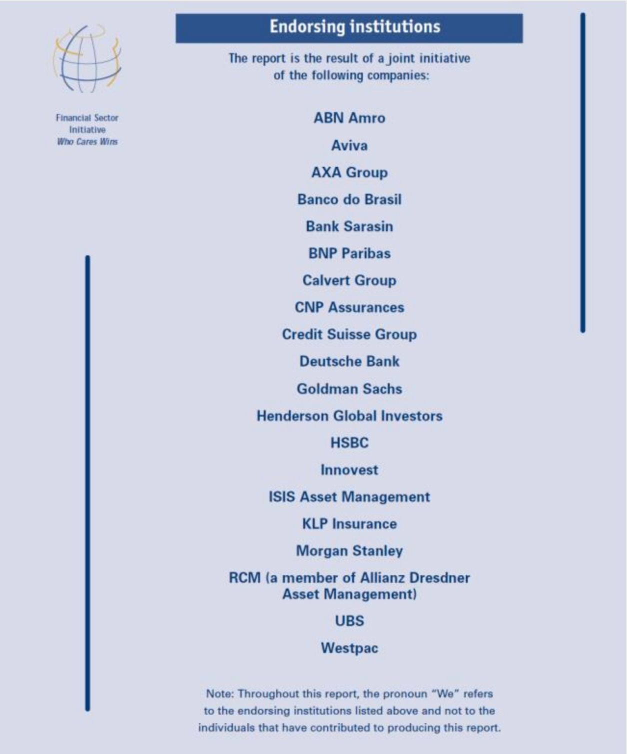
- UN Global Compact 2000 - a CSR initiative launched by Secretary-General Kofi Annan based on voluntary company commitments
- “Who Cares Wins” 2004 a report by financial institutions invited by Kofi Annan to “develop guidelines and recommendations to *integrate environmental, social and governance* issues in asset management, securities brokerage services” and analysis.

- The UN Sustainable Development Goals 2015

- European Green Deal 2019

- World Economic Forum Common Metrics 2020

The institutions endorsing this report are convinced that in a more globalised, interconnected and competitive world the way that environmental, social and corporate governance issues are managed is part of companies' overall management quality needed to compete successfully. Companies that perform better with regard to these issues can increase shareholder value by, for example, properly managing risks, anticipating regulatory action or accessing new markets, while at the same time contributing to the sustainable development of the societies in which they operate. Moreover, these issues can have a strong impact on reputation and brands, an increasingly important part of company value.



Financial Sector Initiative
Who Cares Wins

Endorsing institutions

The report is the result of a joint initiative of the following companies:

ABN Amro
Aviva
AXA Group
Banco do Brasil
Bank Sarasin
BNP Paribas
Calvert Group
CNP Assurances
Credit Suisse Group
Deutsche Bank
Goldman Sachs
Henderson Global Investors
HSBC
Innovest
ISIS Asset Management
KLP Insurance
Morgan Stanley
RCM (a member of Allianz Dresdner Asset Management)
UBS
Westpac

Note: Throughout this report, the pronoun "We" refers to the endorsing institutions listed above and not to the individuals that have contributed to producing this report.

Do you remember the BRIC countries?

ESG Research

STANFORD CLOSER LOOK SERIES

SEVEN MYTHS OF ESG

BY DAVID F. LARCKER, BRIAN TAYAN, AND EDWARD M. WATTS
NOVEMBER 4, 2021

STANFORD CLOSER LOOK SERIES

ESG RATINGS
A COMPASS WITHOUT DIRECTION

BY DAVID F. LARCKER, LUKASZ POMORSKI, BRIAN TAYAN, AND EDWARD M. WATTS
AUGUST 2, 2022

HARVARD | BUSINESS | SCHOOL

ESG: Hyperboles and Reality

George Serafeim

ESG Investing: Why Here? Why Now?

Jonathan R. Macey, Yale Law School; Research Fellow at the Law & Economics Center at Antonin Scalia Law School, George Mason University

OCTOBER 2021

Financial Management

ORIGINAL ARTICLE | Open Access

The end of ESG

Alex Edmans

Is History Repeating Itself? The (Un)Predictable Past of ESG Ratings

European Corporate Governance Institute – Finance Working Paper 708/2020

59 Pages • Posted: 5 Nov 2020 • Last revised: 1 Sep 2021

Florian Berg
Massachusetts Institute of Technology (MIT) - Sloan School of Management

Kornelia Fabisik
University of Bern; Frankfurt School of Finance & Management

Zacharias Sautner
Frankfurt School of Finance & Management; European Corporate Governance Institute (ECGI)

Review of Finance, 2022, 1315–1344
https://doi.org/10.1093/rof/rfac033
Advance Access Publication Date: 23 May 2022

OXFORD

Aggregate Confusion: The Divergence of ESG Ratings*

Florian Berg[1], Julian F. Kölbel[1,2], and Roberto Rigobon[1]

[1]MIT Sloan, USA, [2]University of Zurich, Switzerland

The Future of Emissions

Jules H. van Binsbergen† and Andreas Brøgger‡

October 14, 2022

ESG Issues

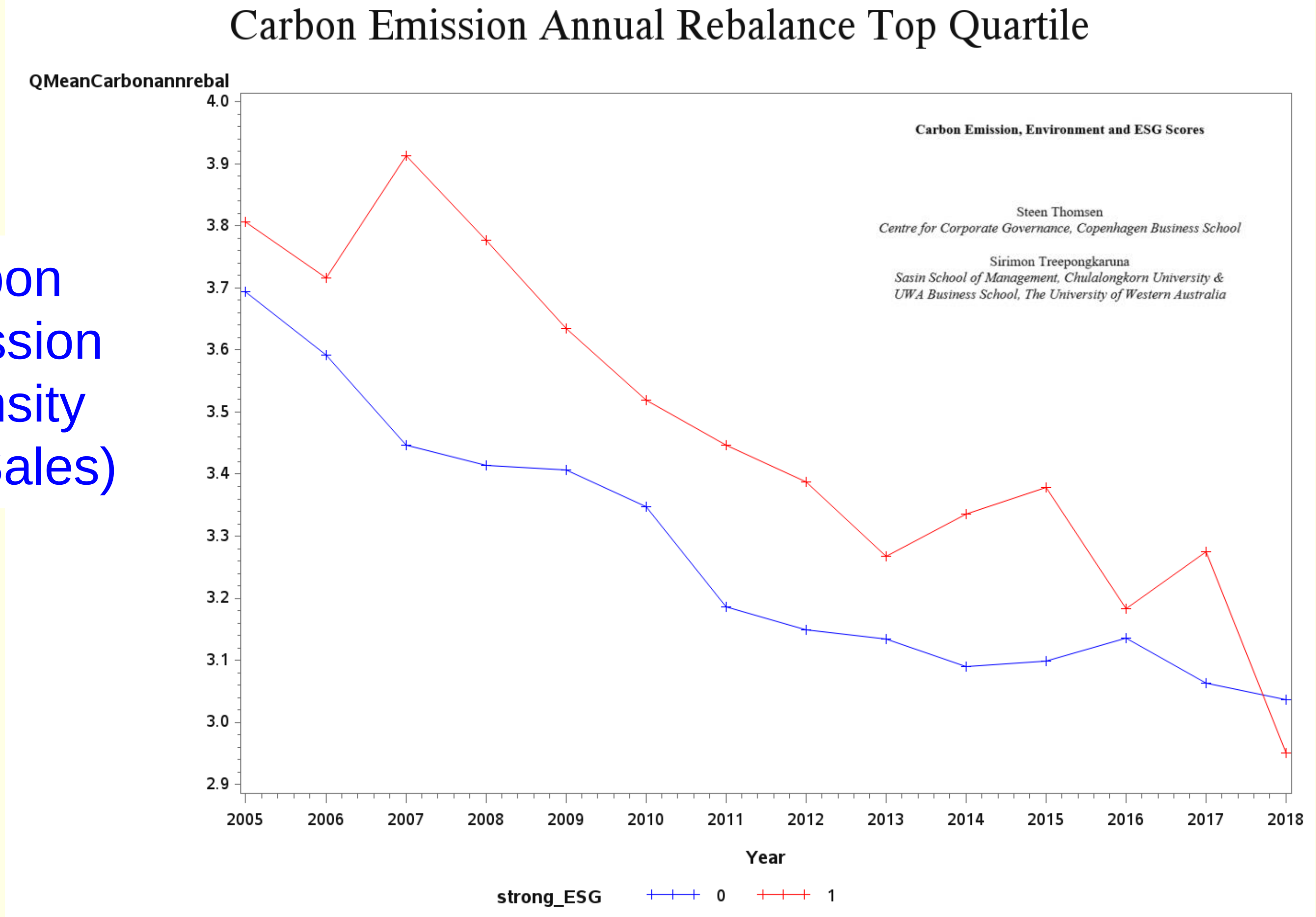
- Confused concept (Larcker 2021, 2022)
- Subjectivity (Berg et al. 2022)
- Continuously retrofitted (Berg et al. 2021)
- High ESG predicts higher carbon emissions (Binsbergen and Brøgger 2022)
- Materiality matters (Serafeim 2021)


SEC chair warns of risks tied to ESG ratings

Jay Clayton says merging separate metrics can lead to imprecise analysis

Rebalanced ESG portfolio (Top 25%)

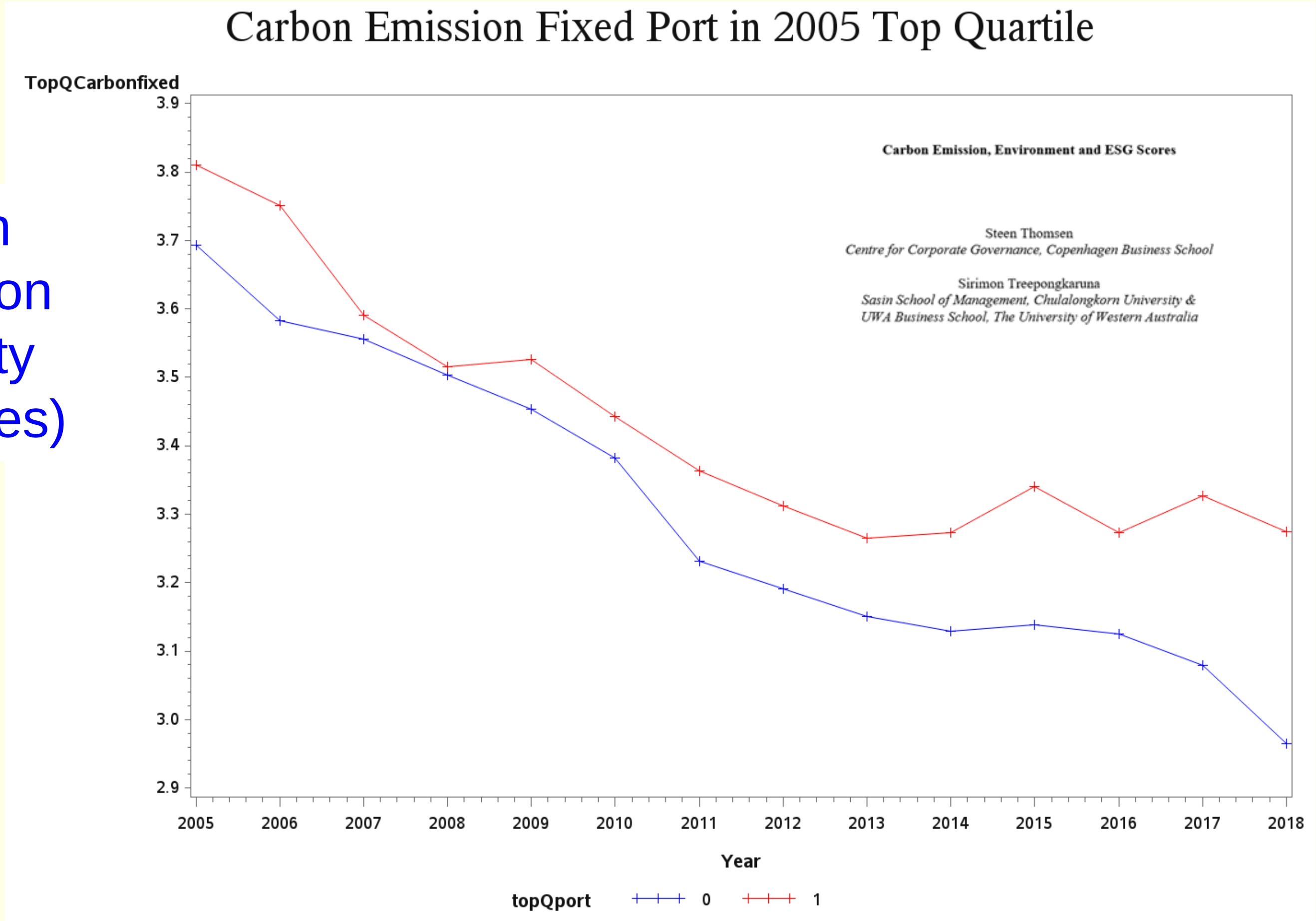
Carbon Emission Intensity (% Sales)



Buy and Hold

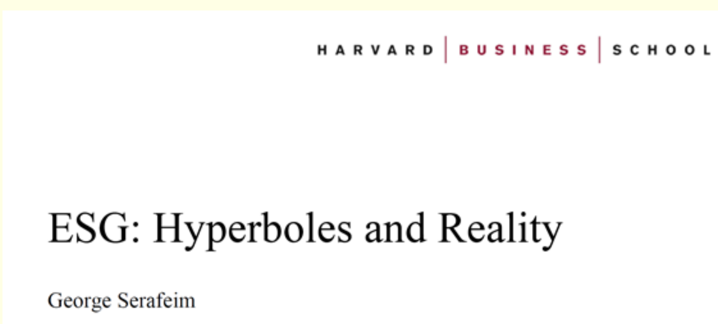
Top 25% ESG portfolio since 2005

Carbon Emission Intensity (% Sales)



Sustainability activism

- Increasing trend
- Better than divesting (Berk and Binsbergen 2022)
  "..the impact (of screening) on the cost of capital is too small to meaningfully affect real investment decisions.."
- Value increasing for material issues
- Value decreasing for immaterial issues

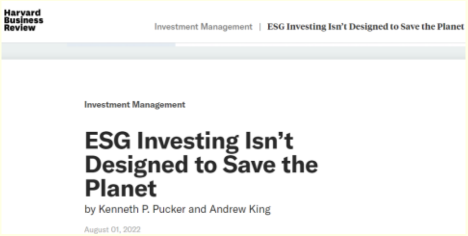

HARVARD | BUSINESS | SCHOOL

ESG: Hyperboles and Reality

George Serafeim

ESG Conclusion

- ESG was invented by the asset management industry
- And profitable for asset managers (fees)
- ESG ratings are deeply flawed, perhaps beyond repair


Harvard Business Review

Investment Management | ESG Investing Isn't Designed to Save the Planet

Investment Management

ESG Investing Isn't Designed to Save the Planet

by Kenneth P. Pucker and Andrew King

August 01, 2022

- But widely used
- Need for relevance (materiality), which is firm specific
- Focus on verifiable variables rather than ratings

Boards

Board Sustainability

- Sustainability committees grow rapidly and create value if they focus (Burke, Hoitash and Hoitash 2019):
- *"65% of the S&P 100 firms and nearly one-fifth of the Russell 1000 have such a committee"*
- Severe lack of board competencies in E (6%) and G (6%) but better in S (21%) among Fortune 100 firms (Tensie 2021)
- Positive (female) gender association with sustainability, perhaps causal (Hsu, Li and Pan 2022)

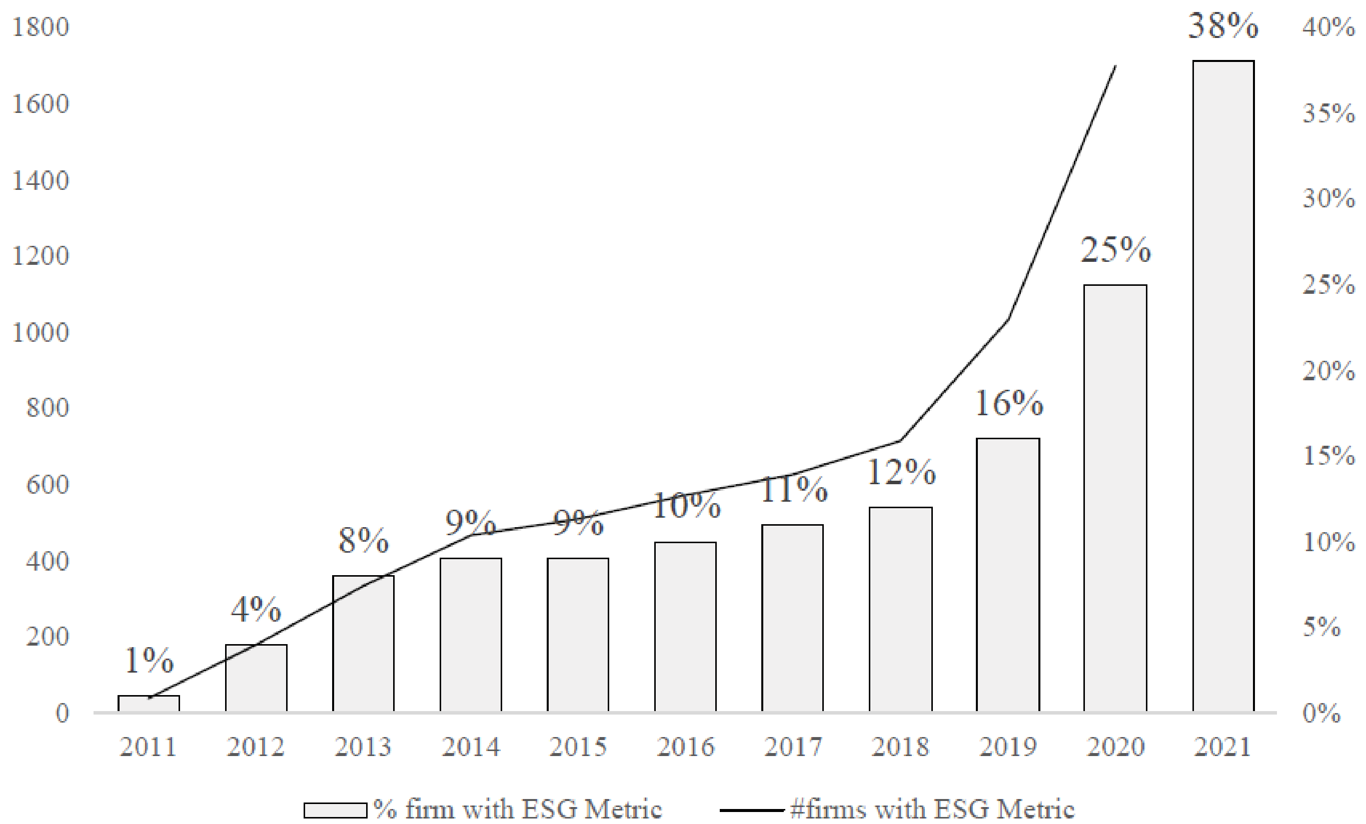
Incentives

ESG incentives

- Fast growth in rated companies (now 38%)
- => improvements in ESG performance
- => negative or insignificant effects on financial performance (Cohen et al. 2022)
- Usually a small component (≈10%)

Figure 1. Use of ESG Metrics in Executive Compensation

This figure shows the evolution of ESG pay (i.e., the inclusion of ESG metrics in executive compensation contracts) over our sample period. The data includes all firms covered by ISS Executive Compensation Analytics (ECA) from 2011 to 2021 (10,061 firms). The bars represent the percentage of firms that include ESG performance metrics in their executive compensation contracts in a given sample year (right axis). The solid line represent the number of firms that include ESG performance metrics in their executive compensation contracts in a given sample year (left axis).



Climate Incentives in Oil majors 2018-2019

Company	Climate Incentive in short term and long-term pay
BP	Sustainable emissions reduction: 10% of short-term pay Low carbon venturing part of strategic objectives which account for 30% of long-term pay
Chevron	Methane emissions intensity combined with safety (15% of short-term pay) No climate incentives in long-term pay
Exxon	Methane reduction part of strategic objectives (long-term pay) No climate incentives in long-term pay
Shell	Greenhouse Gas emission intensity: 10% of short-term pay Strategic objectives (carbon reduction, growing power business, biofuels): 10% of long-term pay
Total	Greenhouse gas emissions: 6% of short-term pay CSR (including climate): 8% of short-term pay No climate incentives in long-term pay

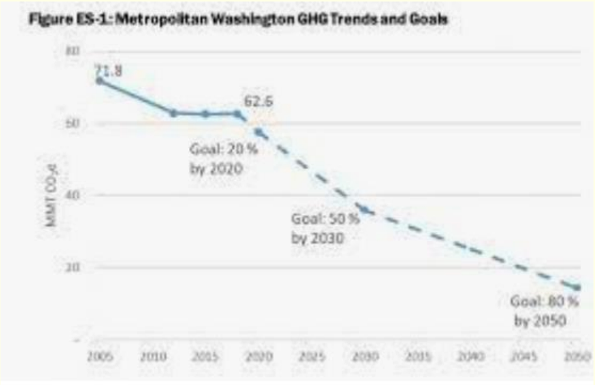
Source: Ritz (2022)

Insignificant?

Management

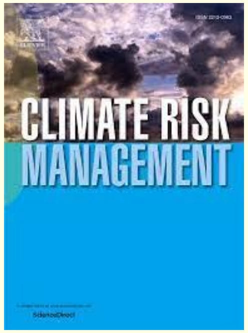
Sustainability Plans

- Climate plans, environmental goals, gender goals….
- Commitment issues
  (Bolton, and Kacperczyk 2022)
- Greenwashing..? Diversity washing….?
- Green pills as a solution?
  (Armour, Enriques, and Wetzer 2022)



Climate risk management

- Heatwaves, extreme weather, hurricanes, rising sea levels, mortality, energy costs, crop yields, biodiversity….
- Already now a significant effect on capital costs => mitigated by risk management (Huang et al. SMJ 2022)



Sustainability reporting

Mandatory CSR and Sustainability Reporting: Economic Analysis and Literature Review

Finance Working Paper N° 623/2019
May 2021

Hans B. Christensen
University of Chicago

Luzi Hail
University of Pennsylvania and ECGI

Christian Leuz
University of Chicago, NBER, CFS, University of Pennsylvania - Wharton Financial Institutions Center, CESifo Research Network and ECGI

- Forecasted to equal financial reports
- Single or double materiality?
- Value relevance?
- Voluntary reporting: greenwashing
- Mandatory reporting standards as a solution?
- Disclosure, litigation and exit cost

DIRECTIVE (EU) 2022/2464 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

of 14 December 2022

amending Regulation (EU) No 537/2014, Directive 2004/109/EC, Directive 2006/43/EC and Directive 2013/34/EU, as regards corporate sustainability reporting

(Text with EEA relevance)

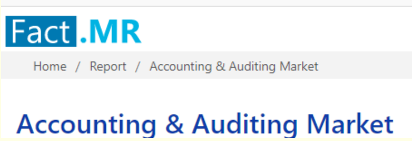
Sustainability Reporting
Back of the Envelope Cost Estimate

- Global Audit Market $bn 217.74
  ≈ 0.2% of global GDP
- 2x (Sustainability Reporting)
  ≈ 0.4% of Global GDP

- ≈ 5% of Global Green Transition Investment

Internal Carbon pricing

- Emissions reductions
  (Bird, Cooperman and Hickman 2020)
- Other cost reductions
  (Ma and Kuo 2021)



- What carbon price? 2$ a ton? 80$?
- What about the revenue?

Conclusion

- Sustainability is here to stay,
- but ESG ratings are deeply flawed
- Need to focus on material issues, which are industry and firm specific
- Purpose needs ownership and board commitment
- Severe environmental competence gap on boards
- ESG incentives depend on materiality
- Sustainability reporting may drive behaviour but is really costly (need to focus on material issues?)

Business Recommendations

- Focus on purpose to define materiality
- Ensure ownership and board commitment
- Upgrade e-competencies
- Reward managers for materiality (purpose)
- Tools like climate risk management, climate plans and internal carbon pricing seem helpful, but need to be flexible
- Don’t rely on ESG ratings

Thanks!