

THE TRIAD COUNTS

ENVIRONMENTAL SOCIAL GOVERNANCE



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The pandemic has accelerated societal, business and political focus on sustainability, and ESG (Environment Social Governance) is now widely understood to be business critical. Why? In part, because it is on the long-term agenda of almost all large institutional investors, the largest owners of European blue-chip companies. These investors have multiplied global sustainable investment assets in the past decade with no sign of slowing the pace.

The foundation for the current boom in ESG investments was laid in the 2010s, after the 2008 financial crisis forced a reckoning on trust in capital markets. Financial crisis investors and companies soon sharpened their focus on restoring faith in the system, with the early 2010's dominated by the rollout of new governance laws and best practice codes for companies and investors.

Later, the 2015 Paris Agreement triggered a clear connection between financial systems and climate change. According to the Agreement, "finance flows have to be made consistent with a pathway towards low greenhouse gas emissions...". Quickly this idea spread beyond climate change – opening a wider discussion around aligning global financial flows with sustainable economic development.

While the "G" and the "E" gained significant momentum in this context, the "S" only truly surfaced as business critical during COVID. The pandemic crisis has created awareness of the vital importance of human capital, diversity, and workers' rights for business growth coupled with a sustainable future.

Good Governance as the Essential Base for a Sustainable Business

No matter which aspect of ESG public debate focuses on in the current moment – companies must understand and view ESG as a triad. A good corporate governance system is a prerequisite to meet investors' demands on environmental and social issues. It not only ensures transparency and accountability; it also creates business resilience. More fundamentally, good governance provides business leadership with license to operate to shape long-term corporate success. Institutional investors increasingly expect companies to link all three ESG components to its business model and embed them into their corporate strategy.

ESG Becomes the New Norm for Companies and Investors

The next phase of good governance in the years ahead will be a holistic approach towards a sustainable corporate governance – where the “E”, “S”, and “G” merge. This will result in the need to implement ESG expertise at board level, as large asset managers and institutional investors increasingly expect to regularly engage with board members on ESG issues. The annual CEO letters from BlackRock and State Street clearly show this new direction.

The direction is clear: ESG integration will become the standard practice for asset managers and institutional investors. But so far there has been limited guidance on how their investment approach will change and the sort of interim targets that might be adopted. In addition to existing frameworks, ratings, and benchmarks, the industry is working on common standards. According to a Blackrock study from last autumn, poor quality or availability of ESG data and analytics is the main obstacle for investors to invest even more sustainably.

The EU taxonomy will be the most relevant standard for defining what environmentally sustainable economic activities are. While these rules apply directly within the EU, the detailed sectoral guidance they provide are likely to be used globally in coming years. This increased focus on companies' ESG record means sustainability topics must be integrated into CEO and corporate communications.

In addition, the pressure on companies in terms of climate targets will likely increase post-COP26 in November, the most important sustainability event since 2015. Companies should anticipate a tightening of existing climate targets and a new scope of action for companies.

ESG practices will be more and more integrated in all economic sectors. Companies that ignore to act on ESG will most likely face greater risks, whereas ESG leaders will take advantage of new opportunities. The ship has not completely sailed yet. There are still various opportunities for companies and investors to engage and shape the discourse and standards, but one thing is clear: There will be a competitive advantage for those who embrace ESG holistically.