CAPCO

ESG: ENVIRONMENTAL, SOCIAL, AND GOVERNANCE CRITERIA

ESG DEFINED

Environmental describes how an organization interacts with its surroundings in its operations, including how consumers use the company's products.

Social (as in responsibility) defines interactions with society. Companies have stakeholders - those who affect or are affected by the company. Social responsibility makes all of society's stakeholders in the company, including future members of society. It is more than philanthropy. Charitable works are part of the company's social footprint, but relationships characterize our responsibility to society.

Corporate **Governance** is about who runs the company and how they are running it. How are employees treated? Customers? Does the company exceed federal guidelines for accountability, safety, diversity, and environmental compliance?

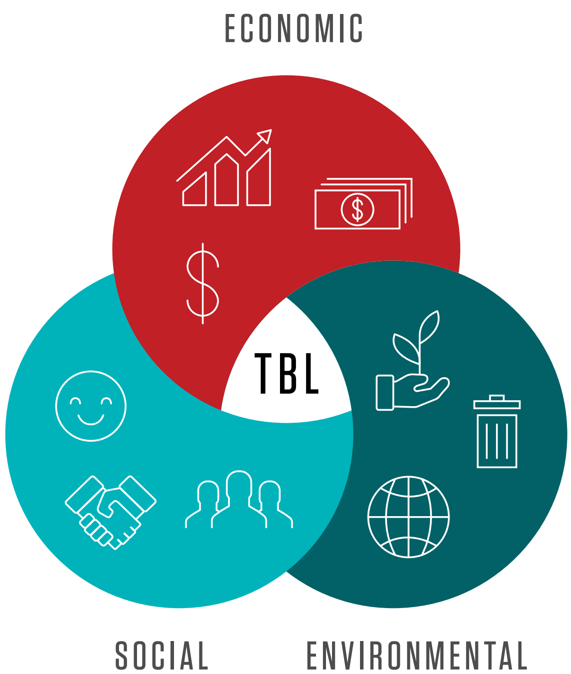
Environmental responsibility, social relationships, good governance all imply good stewardship. **Stewardship** means the careful and responsible management of something entrusted to one's care – e.g., the environment, the global community, stakeholder relationships, employee relationships, and future generations.

Companies have standards and procedures in place for **HSE** or **HSSE** (Health, Safety, (Security), Environment). HSE is a framework that provides governance while adhering to local, state, and federal rules in the areas mentioned above. ESG principles are an extension of these standards.

In summary, ESG = **Sustainable.**

THE HISTORY OF ESG

ESG can partly be traced to the 1970s, when Reverend Leon Sullivan used his position as a board member of General Motors to heighten the awareness of U.S. companies to the race situation in South Africa. When the Congressional Anti-Apartheid Act of 1986 passed, the Sullivan Principles were an integral inclusion. By 1987, 125 US companies had subscribed.



In 1998, John Elkington, co-founder of SustainAbility, published Cannibals with Forks. He defines the **triple bottom line (TBL)** consisting of three pillars: Economic (profit), Environmental sustainability, and Social responsibility. (Amazon Books)

Quadruple bottom line (QBL) - The TBL can be extended to include a fourth pillar: a **future-oriented approach** that emphasizes sustainable development. (Waite, Marilyn (2013-11-18). "SURF Framework for a Sustainable Economy." Journal of Management and Sustainability. 3 (4): 25. doi:10.5539/jms.v3n4p25. ISSN 1925-4733.)

The SURF framework consists of supply chain, user, responsibility, and future. (see Waite reference above). This 2013 paper is a treasure trove of well-organized information with carefully documented sources. It explains SURF using an example of a product; a t-shirt manufactured from bamboo textiles.

In December 1983, The Brundtland Commission was established by the United Nations to unite countries in their sustainable development. Gro Harlem Brundtland was appointed chairperson. The pillars of sustainable development encouraged by the commission include economic growth, environmental protection, and social equality.

In 1992 the commission published Agenda 21, a 351-page comprehensive global action plan – evolving into Agenda 2030.

In September 1999, the Dow Jones Sustainability World Index (DJSI World) launched – based on the top 10 percent of the largest 2,500 stocks in the S&P Global Broad Market index and their sustainability and environmental practices. DJSI World - Investopedia

In 2005, The Dow Jones Sustainability North America Index, or DJSI North America, was launched. It is a stock index that captures the top 20 percent of the largest 600 stocks in the S&P Global Broad Market Index (BMI) based on their ESG practices. DJSI North America - Investopedia

In 2008, The Dow Jones Sustainability North America 40 Index and the Dow Jones Sustainability United States 40 Index were both launched. Those subsets deal with the top 40 sustainability-driven companies, both in the U.S. or in North America. DJSI North America - Investopedia

In 2018, Yahoo! Finance started publishing 'Sustainability Scores' on their website, provided by Sustainalytics, Inc. The three risk areas they score are Environment, Social, and Governance, along with a "significant controversy level" indicator.

In an interview at the 2019 IADC HSE&T Conference in Houston on February 5, 2019, Kaitlyn Allen of Global Affairs Associates said that **HSE professionals have a role to play as the adoption of ESG Integration Approach increases.** International Association of Drilling Contractors HSE conference (ESG). Her interview highlighted three driver categories:

1. The evolution of global risk – including financial stability, government stability, economic and political impacts

2. Correlation to market capitalization – there is a growing body of evidence that certain ESG factors correlate to stock value.

3. The great wealth transfer – between 23 and 30 trillion dollars of wealth will be passed from the boomer generation to millennials, who demand more accountability.

Ms. Allen refers to "the wild west of ESG reporting" because there are many conflicting ESG scoring frameworks. A company can receive over a hundred different surveys, generating "survey fatigue." Those that collect ESG data are not familiar with each company, leading to inconsistent ratings – one survey may list a company in the top five percent of companies in their industry. Another survey framework may rate the same company in the bottom 20 percent.

"In 2018, one in every four dollars invested in the U.S. was aligned with a sustainable, responsible, or impact (SRI) investment strategy, thanks to widespread ESG incorporation in investment vehicles." -- Rate the Raters 2019: Expert Views on ESG Ratings

The key takeaways from this report are that ESG experts in the U.S. and Europe have different views on which ESG rating frameworks are best. Experts would like it to be easier for companies to respond and engage. They expressed a need for greater normalization of ratings across industries.

In March 2020, SustainAbility* published their next report in the series, Rate the Raters 2020: Investor Survey and Interview Results. The report says that corporate practitioners and colleagues are encourage by increased investor interest in ESG performance, struggling with allocating limited resources to ESG data collection and reporting.

Some ratings are based on surveys and responses. Others are passive, relying on public corporate reporting. ESG data is processed and ratings generated often with proprietary scoring.

Companies that dedicate staff to ESG reporting still struggle with the hundreds of hours of work necessary to manage ESG ratings. Those that cannot spend resources on ESG data will be reported through the "default" corporate reporting.

Top ESG Data and Ratings Framework Providers – extracted from Rate the Raters

COMPANY	ACTIVITY	WHEN
Bloomberg	bought New Energy Finance	Dec 2009
ISS	acquired Ethix SRI Advisors, IW Financial, South Pole Group's Investment Climate Data Division, Oekom Research	Sep 2015. Jan 2017. Jun 2017. Mar 2018.
Morningstar	bought 40% of Sustainalytics	Jul 2017
Moody's	acquired Vigeo EIRIS (majority stake), Four Twenty Seven (majority stake)	Apr 2019. Jul 2019
MSCI	acquired RIskMetrics (Innovest, KLD), GMI Ratings (The Corporate Library), Carbon Delta	Mar 2010 (Feb 2009, Nov 2009), Jun 2014 (Jul 2010), Sep 2019
S&P	bought Trucost	Oct 2016
S&P Global	bought SAM ESG ratings from RobecoSAM	Dec 2019
Sustainalytics	(40% belongs to Morningstar) Bought GES International, Responsible Research, Jantzi Research Inc	(Jul 2017). Jan 2019. Jun 2012. Sep 2009.
Thomson Reuters	acquired FC BI, parent of Ethical Corp, Asset 4	Oct 2019. Nov 2009
Vigeo Eiris	(majority belongs to Moody's) Vigeo and EIRIS merged	(Apr 2019). Oct 2015

This paper goes on to present a timeline involving about thirty companies involved in ESG reporting, and the merger and acquisition activity.

At the end of 2019, there were ten companies left.

For example, in July 2017, Morningstar acquired 40 percent of Sustainalytics, the company that provides ESG ratings for Yahoo Financial.

This report explains how investors use different rating frameworks for different areas; respondents may think that one ESG company is better with corporate governance and another with the environment.

My key takeaway from this article is that companies that are concerned about their ESG ratings may need to respond to several of the ESG survey takers, staying aware of how their ESG footprint is presented in the various frameworks.

On May 13, 2020, an article appeared in LAW360 (A LexisNexis Company) Flurry of SEC Activity Shows Interest in ESG Terminology by Mary Beth Houlihan and Donna Mussio. They say:

Open-end and exchange-traded funds with a focus on sustainability attracted $20.6 billion of total new assets in 2019, which is almost four times as much as the $5.5 billion in 2018 — the previous high bar. [Jon Hale, Sustainable Fund Flows in 2019 Smash Previous Records, Morningstar (January 10, 2020)]

The naming of these funds is the issue. The SEC names rule prohibits registered investment companies from using "materially deceptive or misleading names." The rule does not apply to fund names that incorporate terms like 'growth' and 'value' – these denote strategies, not types of investments. Some funds describe the terms 'ESG' and 'sustainable' as investment strategies, side-stepping the names rule.

The SEC is managing this with a "request for comment" with several specific questions about ESG funds. Suffice it to say that this requires better ESG reporting by the companies in that fund's portfolio.

*In 2010, SustainAbility, an ESG think tank, launched a research program, Rate the Raters, "designed to influence and improve the quality and transparency of corporate sustainability ratings." The two reports referenced above are the most recent reports in this program. SustainAbility, is an ERM Group company.

OPPORTUNITIES IN THE ESG ARENA

A company's ESG metrics must be accurate and as consistent as possible in the prevailing ESG metric frameworks. Ambiguous or incomplete data can lead to misunderstandings, as well as accusations of 'Greenwashing.'

Capco can provide the following services:

- Analyze our client's ESG footprint
- Research ESG frameworks and reporting requirements
- Recommend changes in operations and/or reporting that may improve the ESG metrics
- Collaborate with our client to present corporate reports and social media information to showcase the positive ESG footprint that investors are seeking.

AUTHORS

Craig Mellott, Principal Consultant
Shannon Shubert, Managing Principal

ABOUT CAPCO

Capco is a global technology and management consultancy dedicated to the financial services industry. Our professionals combine innovative thinking with unrivalled industry knowledge to offer our clients consulting expertise, complex technology and package integration, transformation delivery, and managed services, to move their organizations forward.

Through our collaborative and efficient approach, we help our clients successfully innovate, increase revenue, manage risk and regulatory change, reduce costs, and enhance controls. We specialize primarily in banking, capital markets, wealth and asset management and insurance. We also have an energy consulting practice in the US. We serve our clients from offices in leading financial centers across the Americas, Europe, and Asia Pacific.

To learn more, visit our web site at **www.capco.com**, or follow us on Twitter, Facebook, YouTube, LinkedIn and Instagram.

WORLDWIDE OFFICES

APAC
Bangalore
Bangkok
Hong Kong
Gurgaon
Kuala Lumpur
Mumbai
Pune
Singapore

EUROPE
Bratislava
Brussels
Dusseldorf
Edinburgh
Frankfurt
Geneva
London
Paris
Vienna
Warsaw
Zurich

NORTH AMERICA
Charlotte
Chicago
Dallas
Houston
New York
Orlando
Toronto
Tysons Corner
Washington, DC

SOUTH AMERICA
São Paulo

WWW.CAPCO.COM

CAPCO