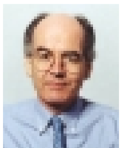
DEALING WITH THE BIG ISSUES



CORPORATE SOCIAL RESPONSIBILITY IS CLIMBING HIGH ON FIRMS' AGENDAS SO BEWARE THOSE TREASURERS WHO HAVE NOT DONE THEIR HOMEWORK, SAYS **JOHN ELKINGTON** OF SUSTAINABILITY.

Most chief financial officers, corporate treasurers and company secretaries have escaped the full force of the environmental revolution, but that was before climate change stormed onto the agenda.

Several years ago, I was deep in conversation with a leading US corporate governance expert on the top floor of the Ford Motor Company's world headquarters building in Detroit. I argued that we would soon see the convergence of the corporate governance and corporate responsibility agendas. His response was simple: the two agendas were separate, he countered, and would always remain so. How the world has changed.

Recent years have seen corporate governance pushed to centre stage, particularly in the wake of the US corporate controversy. The wave of corporate governance scandals are predicted to cost the US economy $35bn (£22bn), as much as a $10-a-barrel rise in the price of oil, according to the Brookings Institution. And that is not all – we are also seeing the corporate governance agenda hybridising with the wider corporate social responsibility (CSR) and sustainable development (SD) agendas.

Chief financial officers, corporate treasurers and company secretaries are being dragged into the fray. Take the case of the Dow Jones Sustainability Group indexes (DJSGI), launched a couple of years back by the New York-based Dow Jones Group and Zurich-based Sustainable Asset Management. When the DJSGI questionnaire thudded through corporate letterboxes it attracted disproportionate attention from financially minded executives, largely because the Dow Jones involvement signalled a further step in the mainstreaming of the CSR and SD agendas.

We should not be surprised. Most of the issues now impacting business could have been – and often were – predicted years ago. The EU is still the leading incubator of new social and environmental issues, but the US is often pioneering in terms of the market responses to some of the resulting 'big issues'. One driving factor for both regions has been the almost exponential growth in financial risks and liabilities. Some 20% of the losses that almost brought down the Lloyd's insurance market, for example, were related to exposures, particularly in the US market, to such problems as asbestos, contaminated land and radioactive waste.

THE BILL ACCUMULATES. Major liabilities have surfaced in a growing range of sectors, notably in those producing and using asbestos. Indeed, asbestos litigation has expanded to embrace so many companies that it is now estimated to affect 85% of the US economy, according to the Rand Institute for Civil Justice. In what has now become the longest-running mass tort litigation process in US history, the cost of resolving asbestos-related claims had already hit $54bn by 2000.

Nor are environmental issues alone in this field. The tobacco and fast food industries have also been increasingly targeted. But, while the financial liabilities linked to smoking-related diseases or to obesity and other diet-related illnesses are going to be huge, we may well see a wider range of industries much harder hit, both directly and indirectly, because of environmental change processes such as global warming.

Insurers and reinsurers are increasingly anxious. The Munich Reinsurance Group, for example, noted a significant rise in insured natural hazard losses in its 2001 report. That year, 700 natural hazard losses were recorded, with economic losses estimated at $36bn (a 20% increase on 2000) and insured losses totalling $11.5bn (a 50% increase). "Climate change has been a major cause of many natural disasters," Munich Re noted, "and scientists at the group fear it is going to have a continuing effect on company statistics." The company has reassessed the effects of climate change and come up with tighter underwriting requirements, which very likely will raise insurance premiums.

But the fact that such mega-issues are becoming more important should not blind us to the fact that a range of other pressures are building, a number of which have significant implications for the financial performance of common-or-garden companies. Take UK landfill as one example of the trend. These are now predicted to treble from £13- to £35-a-tonne over the next decade, as the Treasury sends "a significant long-term signal" both to business and to local authorities.

THE PUBLIC TEMPERATURE IS RISING. One key pressure is public opinion. Public opinion surveys show that ordinary people are concerned about sustainability-related issues, though there is often a

question mark over their willingness to drive meaningful change. Take Environics International's Millennium Poll, which was published in 2000 and covered 25,000 average citizens in 23 countries on six continents. Among the key conclusions were the following:

- citizens of 13 of the 23 countries thought their country should focus more on social and environmental priorities than on economic goals in the next decade;
- two in three citizens wanted companies to go beyond their historic role of making a profit, paying taxes, employing people and obeying all laws; and
- one in five consumers report said they had 'punished' a company in the past year, based on their perceived social performance.

We can take all of this with a pinch of salt, but such pressures are having an impact on companies. When consultants PricewaterhouseCoopers (PwC) produced a sustainability survey in 2002, covering 140 major companies in the US, headline results included the following:

- 70% were actively reviewing their governance or business ethics;
- 90% said their main concern was corporate reputation;
- 75% said their main reason was to ensure 'sustainable business operations';
- 75% mentioned competitive advantage; and
- 73% pointed to cost savings.

In the process, the agenda is skewing towards board level in companies whose attention has been engaged. Eco Research asked companies where in the company the CSR issue was 'owned'. Interestingly, 76% said the CEO and/or Board; 27% said a dedicated CSR function or department; 16% mentioned a public affairs or PR department; 5% pointed to their human resources department; and 5% mentioned 'other' categories.

VALUES MERGING WITH VALUE. Both in the EU and the US, value creation processes are evolving to embrace a wider range of societal values. One place to look for early evidence is the world of socially responsible investment (SRI). According to the 2001 edition of Nelson's *Directory of Investment Managers*, the growth rate for socially screened portfolio assets was more than 1.5 times that of all professionally managed assets in the US. Professionally managed investment assets grew at 22% from $16.3 trillion in 1999 to $19.9 trillion in 2001, while socially screened assets grew by 36%, from $1.49 trillion to $2.03 trillion.

The US Social Investment Forum says that nearly one out of every eight dollars under professional management in the US is involved in responsible investing. In Europe, total SRI assets increased by 36% from €11.1bn at the end of 1999 to €15.1bn by mid-2001, according to the SiRi Group of social investors. In the UK, according to the UK Social Investment Forum, by August 2001, the retail ethical investment market had grown in value to some £4bn – nearly 2,000 times the original estimate made by City observers.

Another area to look for evidence of building trends is corporate reporting, an area SustainAbility has worked in for the past decade. Although the language used in the latest CSR and SD reports is not yet truly tuned to financial market needs, it is beginning to pick up on financial concerns, such as risk management.

Some companies, too, say explicitly that they are using their sustainability reporting to raise their profile among financial analysts. For example, French energy, waste and water group Suez, in addition to trying to give shareholders an adequate return, also tries to use its reporting to increase its share's visibility.

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They are pleased with their listing in such indexes as the Dow Jones STOXX Sustainability Index. Similarly, Swiss pulp and paper company SCA notes that it now appears in the Dow Jones Sustainability Group Index, the Dow Jones STOXX Sustainability Index and the FTSE4Good Index. It also reports that the New York-based strategic value advisory firm Innovest recently awarded SCA a AAA rating.

In many areas, costs are rising significantly. "There is no danger of us running out of environmental issues to address in industry," says Professor Edward Krubasik, a member of the Siemens Managing Board. In 2001, for example, Siemens spent almost €75m on the environment, using strict definitions of what qualified, including €61m in operating costs and €13m in capital spending. These figures compare with 2001 net sales of €87bn, net income of over €2bn and R&D expenses of €6.7bn.

Or consider UK water company AWG, whose latest sustainability report contains a preliminary set of environmental accounts. These seek to identify and put a value on the most significant environmental impacts caused by AWG's operations – and what the impact on AWG's profits would be if these externalities were to be internalised. Interestingly, the potential negative impact on profits increased from 8.1% in 1999 to 11.9% in 2001, because of the growing use of energy derived from fossil fuels, some of which was linked to higher water and waste treatment requirements.

FACING NEW CHALLENGES. An important new report from rating agency Standard and Poor's (S&P) may be an indicator of where things are headed. In its survey of transparency and disclosure practices of more than 1,500 companies, S&P found a direct correlation between disclosure and both market risk and market valuation.

True, it remains a challenge to capture the value added by all these factors, but The Co-operative Bank estimates that it now owes 20% of its business to its reputation for corporate responsibility. The environmental, CSR and SD agendas, in short, are now surging into the traditional realms of corporate finance and governance. In the process, issues once handled by public affairs and legal people will increasingly be (and be seen to be) mainstream challenges for CEOs, boards, corporate treasurers and chief financial officers.

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