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PARC Discussion Meeting

Getting to Net Zero: the Role of Reward

Wednesday 24th April 2024

Getting to Net Zero: the Role of Reward

Introduction

Steve Toft, Associate, PARC and
Karen Clark, Director, PARC

Access the Report

PARC's starting point for our report and today's event

- **WE HOLD** that we reach Net Zero when the amount of GHG we add is no more **than the amount being re-absorbed from the atmosphere**
- **WE ACCEPT** that global warming is starting to have a significant impact on growth, productivity and public opinion
- **WE ACKNOWLEDGE** that economic losses from climate related events have risen over the last decade – and are increasing sharply during the 2020s
  - Over the next quarter century, the costs of doing nothing are likely to be severe. Oxford Economics calculates a 20% hit to global GDP by 2050 if no action is taken
- **WE ACCEPT** the reality of incalculable human misery and loss of life as potential outcomes of not taking action

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Why Net Zero must matter to our PARC members

Investment, Resources and Risk

- **Economic cost –** new infrastructure and processes; changing consumer demands
- **Reputational cost** – attracting talent and customers; media scrutiny
- **Compliance and regulatory risk** – government regulation; international bodies
- **Supply chain risk** – especially for carbon intensive industry
- **Reward risk** – design and outcomes; avoidance of unintended consequences
- **Workforce and resource planning –** redeployment; investment in reskilling
- **Institutional investors** – expectations and demands

…Viability of future generations

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Increasing focus on companies

- Rising public concern translating into greater political pressure
- Net Zero now enshrined in law – 89% of the world's population and 92% of its GDP are now covered by national Net Zero targets
- 2050 the usual target in advanced economies
- Governments, international bodies and some investors now taking a more directive approach on what companies should do
- Demanding emissions reporting from the entire value chain (Scope 3)
  - UN Integrity Matters report
  - EU Corporate Sustainability Reporting Directive

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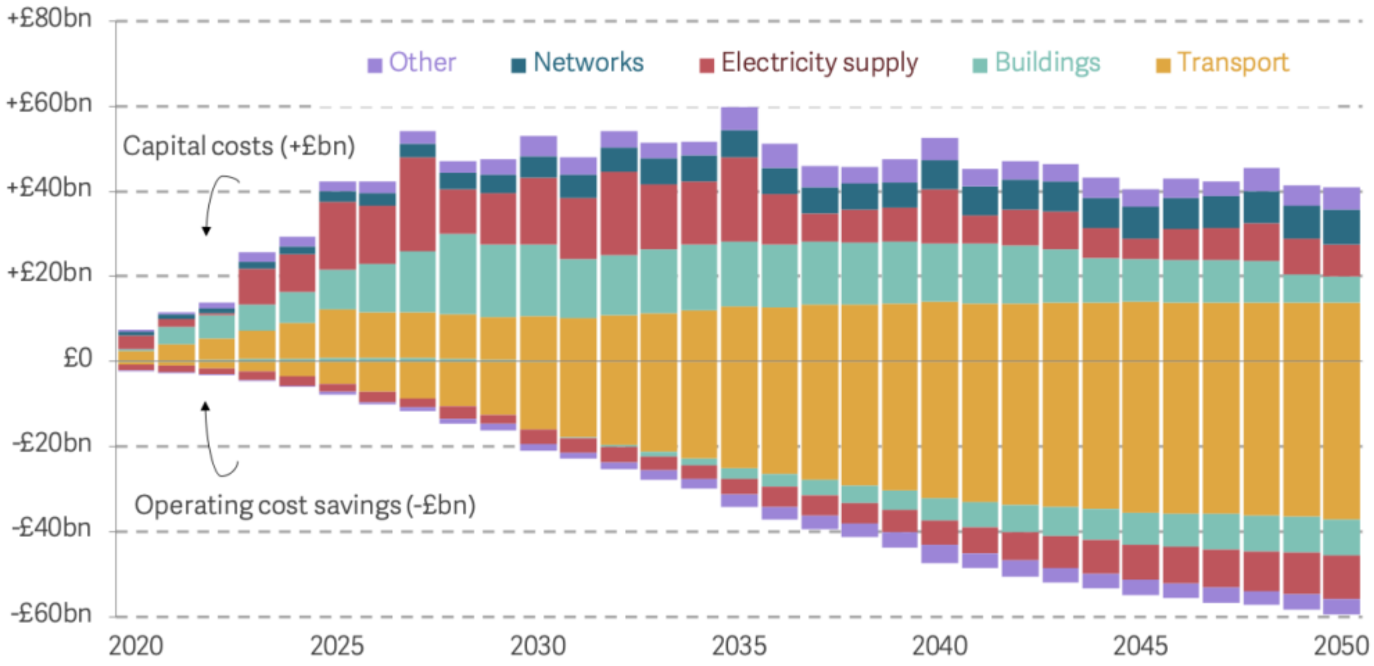
The economics – Short-term pain for long-term gain

The cost savings from a Net Zero pathway will eventually outweigh investment costs

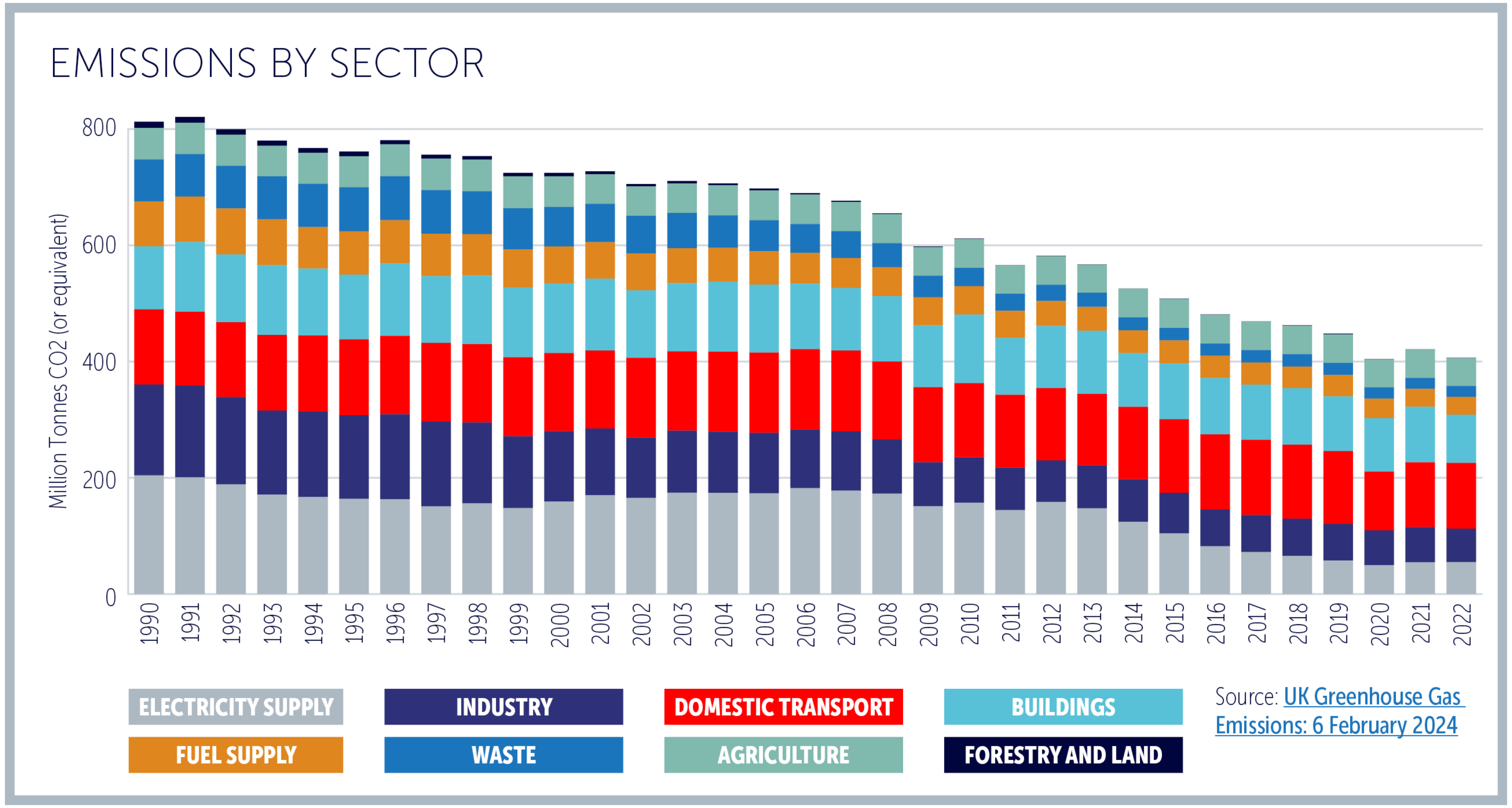
Capital and investment costs and operating cost savings in the Balanced Net Zero Pathway: UK



Notes: Values above the X-axis refer to additional annual capital investment. Values below the x-axis refer to savings due to operating cost reductions.

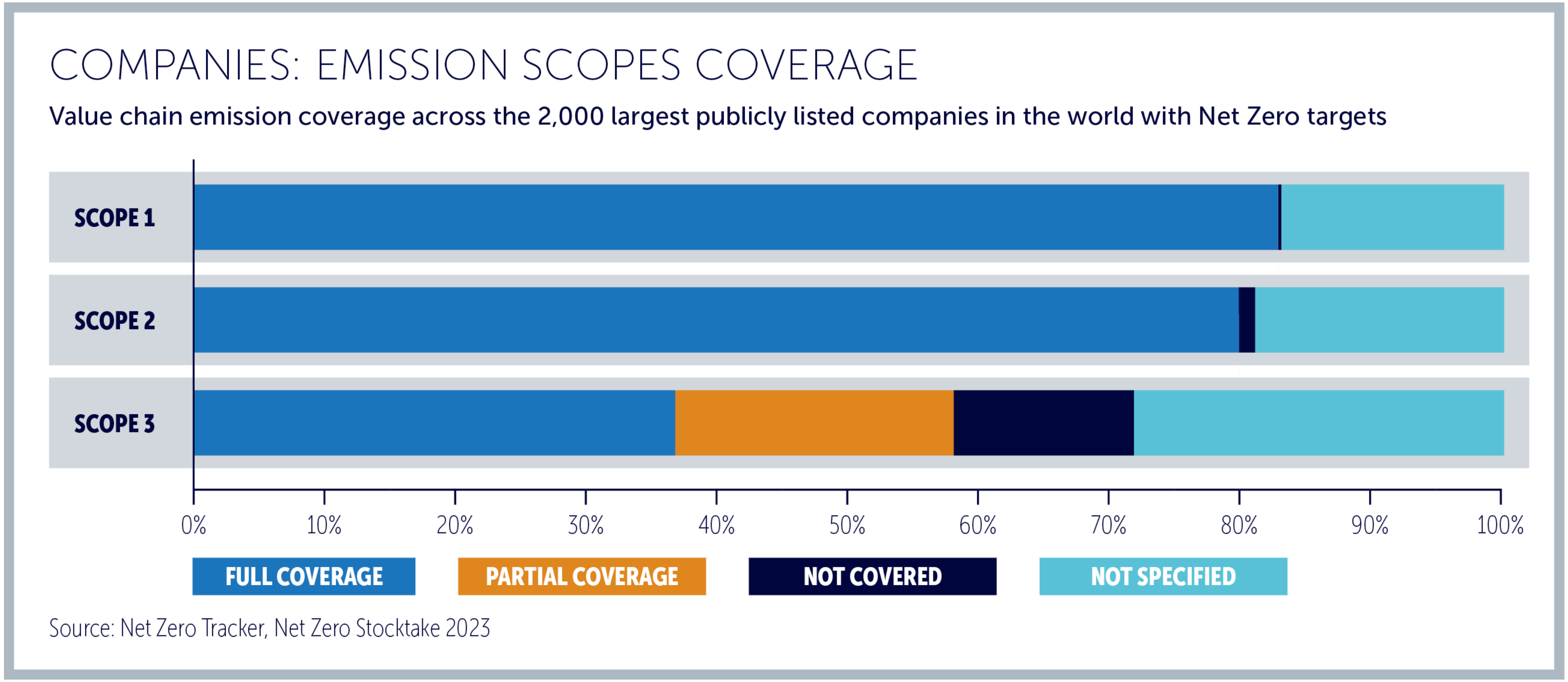
Source: Resolution Foundation's Analysis of Climate Change Committee, The Sixth Carbon Budget: The UK's path to Net Zero, December 2020

One sector has done most of the work



The next stage of decarbonisation will have a major impact on businesses and households

Many companies have a way to go….



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Getting to Net Zero: the Role of Reward

Julie Baddeley, Chair of the Board of Directors, Chapter Zero. Senior and Independent NED

About Chapter Zero

Chapter Zero is a membership organisation. We equip and inspire non-executive directors to lead on climate from the boardroom.

3000
Members

80
Companies in FTSE 100

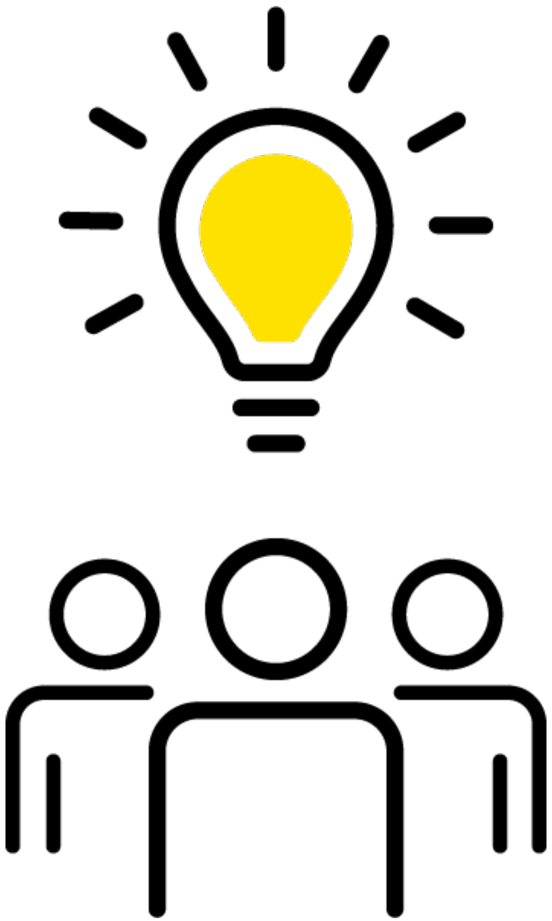
6
Supporting FTSE Chairs

Global network
31 chapters in 72 countries around the world focusing on principles of climate governance in boards, in collaboration with the World Economic Forum.

Chapterzero.org.uk

Join Chapter Zero

Chapter Zero is philanthropically funded and free of charge to join. Sign up at:
Chapterzero.org.uk/register



Ambition

1 Foundations

- 1.1 Strategic Ambition
- 1.2 Business model and value chain
- 1.3 Key assumptions and external factors

Action

2 Implementation Strategy

- 2.1 Business operations
- 2.2 Products and services
- 2.3 Policies and conditions
- 2.4. Financial planning

3 Engagement Strategy

- 3.1 Engagement with value chain
- 3.2 Engagement with industry
- 3.3 Engagement with government, public sector, communities, and civil society

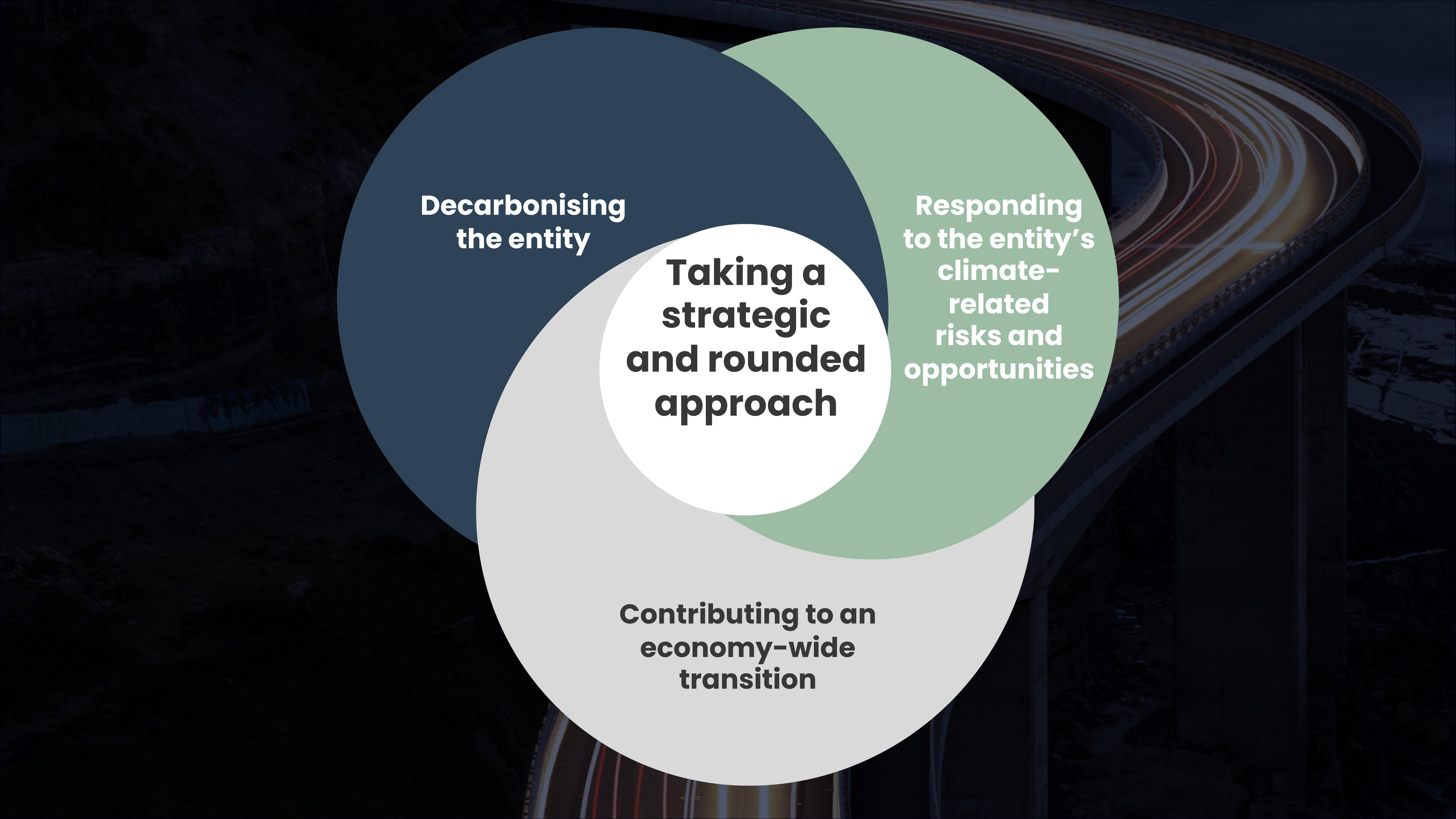
Accountability

4 Metrics and Targets

- 4.1 Governance, engagement, business and operational metrics and targets
- 4.2 Financial metrics and targets
- 4.3 GHG metrics and targets
- 4.4 Carbon credits

5 Governance

- 5.1 Board oversight and reporting
- 5.2 Management roles, responsibility and accountability
- 5.3 Culture
- 5.4 Incentives and remuneration
- 5.5 Skills, competencies and training


Decarbonising the entity
Responding to the entity's climate-related risks and opportunities
Taking a strategic and rounded approach
Contributing to an economy-wide transition

Getting to Net Zero: the Role of Reward

Investor-led Sustainability in Corporate Governance

Prof. Georg Ringe, Professor of Law & Finance, and Director of the Institute of Law & Economics, University of Hamburg

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Introduction

Overview

- Currently, efforts to prescribe sustainability criteria (directors' duties; remuneration; stewardship codes; etc)

- Alternative route: <u>empowering investors</u>
  - Supply and demand for ESG financial products
  - Coalition-building among institutional investors
  - At most, facilitative role for regulation

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(1) ESG in financial markets

The Rise of ESG investment

- Big Three ESG engagement (BlackRock, Vanguard, StateStreet)
  - Run campaigns on climate, diversity, and racial justice
- Other institutional investors: pension funds, mutual funds
  - 42% of US funds now incorporate ESG in investment decisions
- Shareholder activists, halo funds
  - Engine No 1, Inclusive Capital Partners

-> Can the market achieve ESG goals by itself?

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(2) The promise of institutional investors

Three ingredients for an optimistic perspective

(1) Supply side

- offering ESG products motivated by purely financial reasons
- Index fund managers can charge higher fees with sustainable index
- Overcome low fees dilemma
- Example: BlackRock's "iShares Global Clean Energy ETF": charges 40 basis points more than plain vanilla S&P ETF

NB: **Greenwashing** incentive -> need for standardization

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(2) The promise of institutional investors

(2) Demand side

- Shift in preferences of the “millennials” generation
- Wealth accumulation phase; peaking in 2030s
- 63% “improving society” > “generating profit” (Deloitte study, 2020)
- 75% “philanthropists”; 42% engaged in “impact investing” (Fidelity study, 2021)

-> give incentives to *offer* such products

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(2) The promise of institutional investors

(3) Common Ownership

- Fund managers own shares in virtually every firm in the country (even competitors), "own the market"
- Poses competition/antitrust problems
- **Positive effect**: care less about returns of individual portfolio companies, but about the market as a whole
- "Double universality" – represent entire spectrum of (retail) investors; are invested in virtually every firm -> will encourage firms to internalize externalities
- Promote market standards, rather than engagement on the individual firm level
- Cf. Coffee (2020); Gordon (2021): "systematic stewardship": focus on systematic, rather than idiosyncratic risk

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(3) Team-building

Trend towards collaboration

- Traditional context: cooperation between different types of investors, notably activist & passive fund

- Diversified investors ‘follow lead’ of non-diversified, focused investors e.g. hedge funds

- may overcome free-rider problems & improve mgt accountability (Kahan & Rock, 2010; Gilson & Gordon, 2013)

- ‘Vetting process’ as double genius (Ringe 2018): filter for value-creating campaigns

(3) Team-building

Now also observed in ESG investing!

- "Engine No 1" / Exxon, May 2021
  - Partnered with CalSTRS; Church of England; CalPERS; New York State Common
  - Received support from BlackRock and Vanguard
- Elliot / Evergy 2020-21
  - Campaign to foster sustainability transformation
  - Supported by Bluescape Energy Partners
- TCI / Aena, 2020
  - Campaign to adopt "say on climate" at many companies
  - Successful with Aena, supported by Blackrock
- Jana Partners / Apple, 2018
  - Initiative to limit children's screen time on Apple devices
  - Supported by CalSTRS
  - -> "screen time" function

(3) Team-building

Institutionalized platforms

- Climate Change 100+: Launched 2017, now > 500 investors, $54 tr AuM

- UN PRI collaboration platform: see Dimson et al., 2021

- "investor-driven governance networks":
  Carbon Disclosure Project (CDP), Interfaith Center for Corporate Responsibility (ICCR), Coalition for Environmentally Responsible Economies (Ceres), Network for Sustainable Financial Markets (#NSFMNextGen)

- Advocacy platforms, sharing costs, typically one "lead investor" per campaign

- Sometimes, partner with other outside investors

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(4) Implications

Lessons for regulation?

- Prescriptive intervention in corporate law seems unwarranted
- Instead: foster and support “self-regulation”
- Address problems like greenwashing; cost of collaboration; free-rider problems

(4) Implications

(a) Remove obstacles

- Example: U.S. ERISA retirement plan framework

- Trump administration: uncertainty on whether fiduciaries were allowed to invest in ESG funds

- DOL 2022 reform clarifies possibility; treats ESG investment like any other commercial investment (preserving prudence and loyalty)

-> Does not *mandate* ESG investing, but *allows* it

(4) Implications

(b) Remove barriers for cooperation

- Proxy solicitation rules even toughened under Trump administration
- EU/UK rules on "acting in concert" – disclosure and takeover regulation; insider dealing
- US rules on "Fair Disclosure"

ESMA proposal to expand "White List": should include an explicit reference to coordination activities among institutional investors in the area of ESG, to facilitate engagement

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(4) Implications

(c) Disclosure and standardization -> address greenwashing

- Myriad of international standards: SASB; GRI; WEF; TCFD

- US: no regime exists; SEC has proposed controversial rules

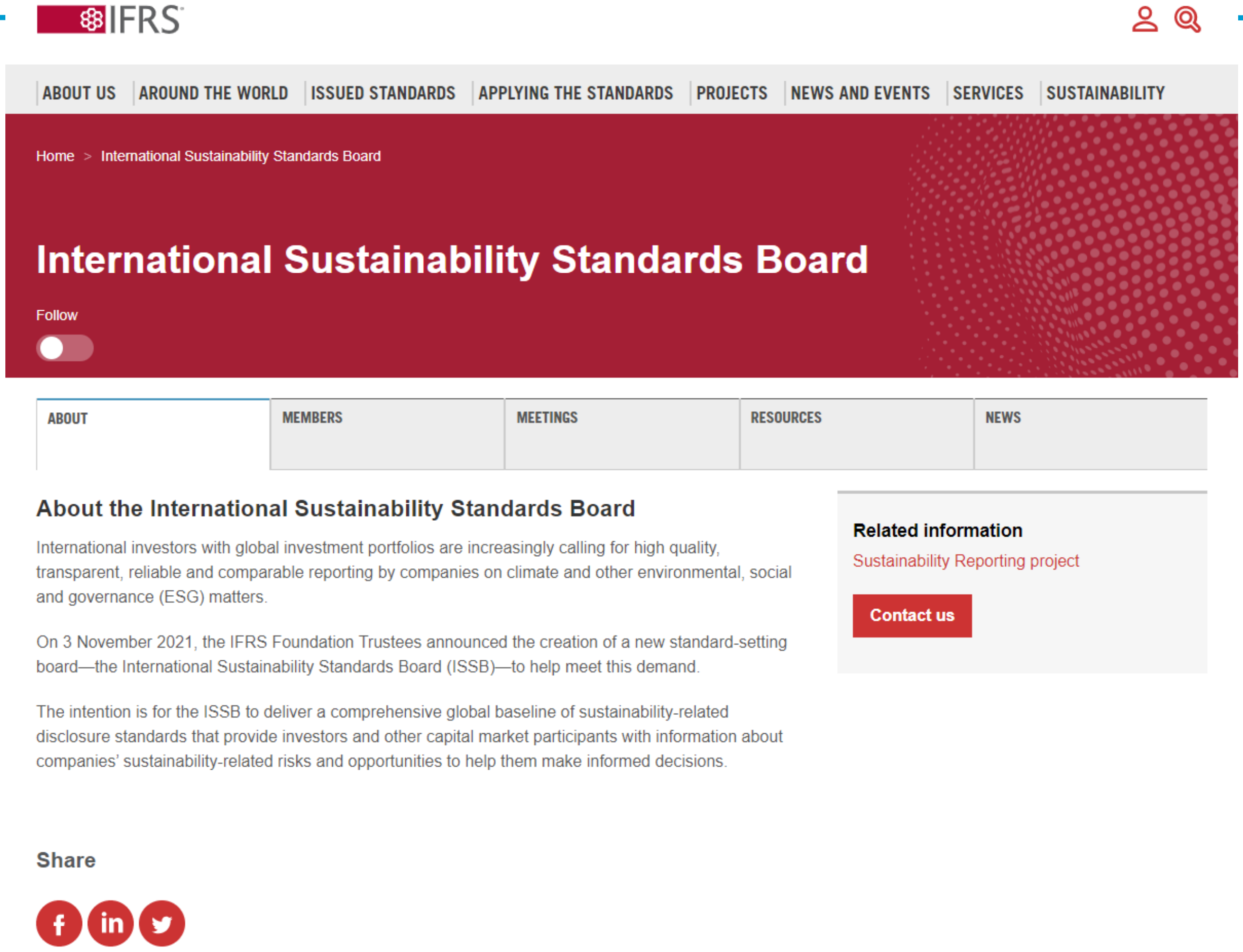
- EU: Corporate Sustainability Reporting Directive (CSRD), Taxonomy Regulation, Sustainable Finance Disclosure Regulation (SFDR)

- UK: comply-or-explain disclosure framework in line with TCFD for premium-listed issuers; mandatory disclosure regime in preparation

Problems?

Globally unequal standards

- Jungle of international regulatory standards – global and national
- New: International Sustainability Standards Board (ISSB), Frankfurt
- Conflict with the EU?



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Problems?

Political trench welfare

- Political influence on criteria
- Example: Definition of nuclear energy as ‘sustainable’ / German-French conflict
- Compromise solution: both nuclear energy and natural gas sustainable
- May undermine credibility of the Taxonomy

Problems?

ESG

Arbitrage possibilities: “Brown Spinning”

Regulatory focus and investor pressure mainly on public firms, not on private

-> Public companies move “brown” assets into unlisted (private) companies (Gözlügöl & Ringe 2023)

- **Embellishment of green performance**; may give wrong impression
- Brown assets escape disclosure obligation
- Role of private equity

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(5) A positive outlook

Positive factors

- Power and influence of investors
- Alliances between investors and investor groups
- Institutional platforms – information exchange, cost sharing

- Regulation should play a supportive, facilitative role
- More dynamic development and adjustment

Wolf-Georg Ringe

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My research is available at
https://ssrn.com/abstract=3958960

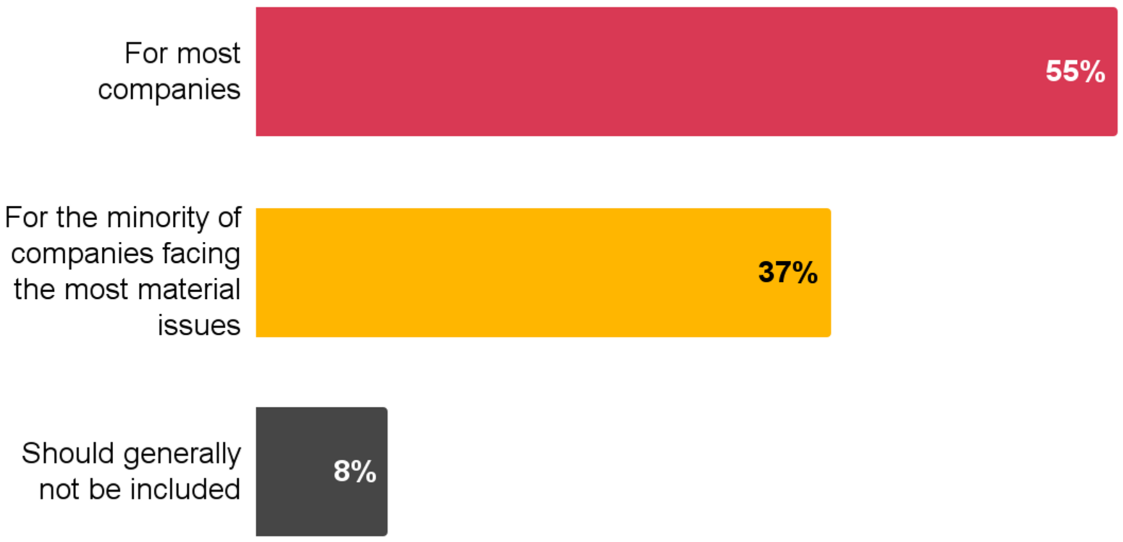
Getting to Net Zero: the Role of Reward

Andrew Page, Partner,
PwC's People and Organisation Practice

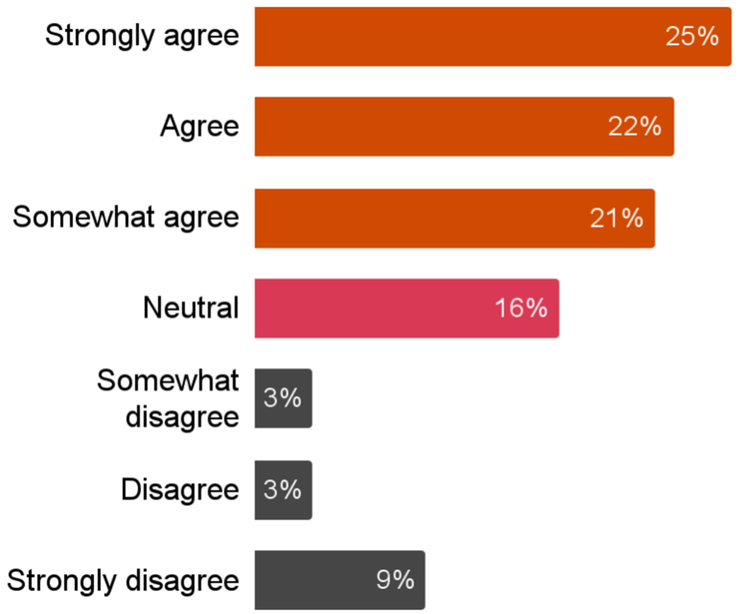
Rewarding for Net Zero
Majority of senior leaders and investors believe pay should be linked to ESG

Broadly consistent views across senior leaders and investors

Senior leaders: Should ESG measures be in included in executive pay?

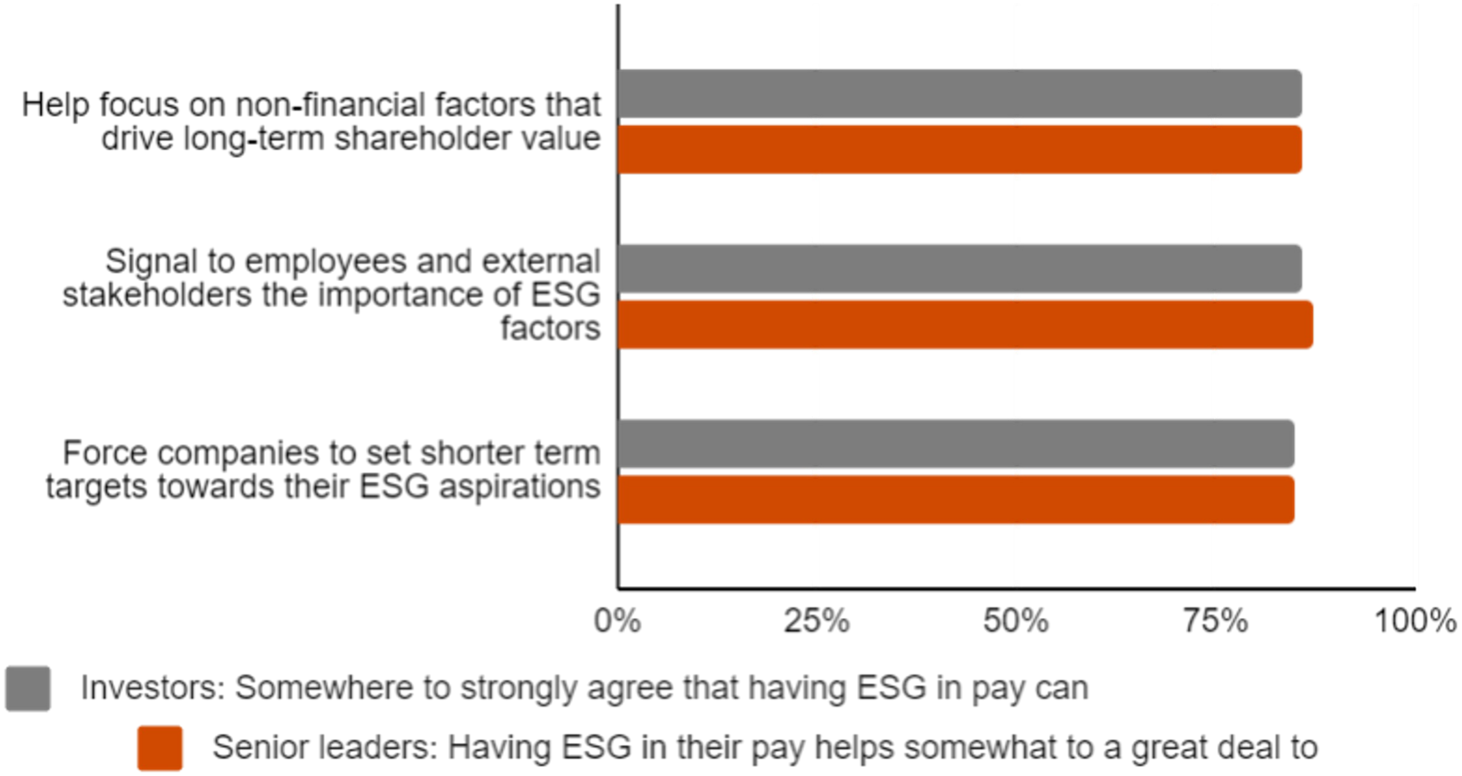


Investors: Do you think ESG performance measures and targets should be included in executive pay arrangements?



Investors and senior leaders agree on benefits of linking ESG to pay

Top three benefits of linking ESG to pay



Helps focus on non-financial factors that drive long-term value

Signals to employees and external stakeholders the importance of ESG factors

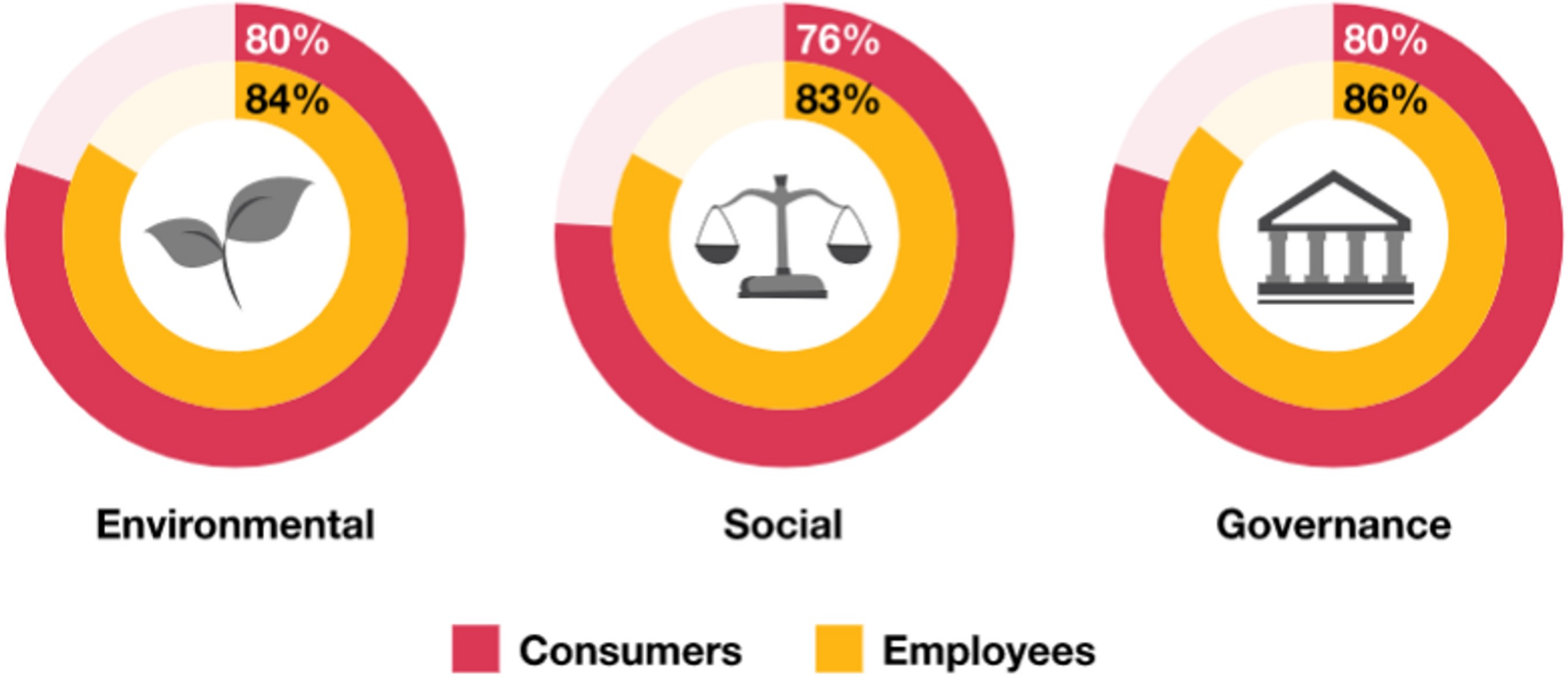
Forces companies to set shorter term targets towards their ESG aspirations

Consumers and employees care about ESG

What are customer and employee expectations regarding ESG?

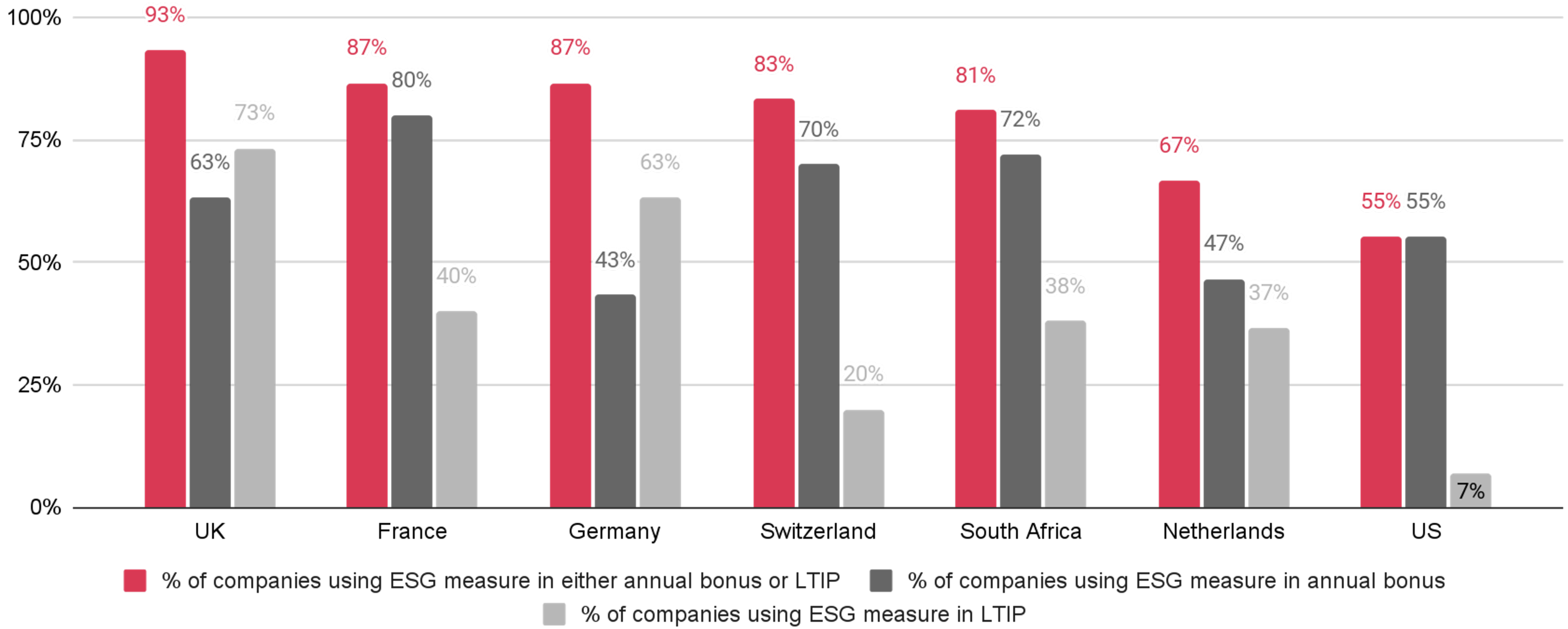
?

I am more likely to buy from / work for a company that stands up for...



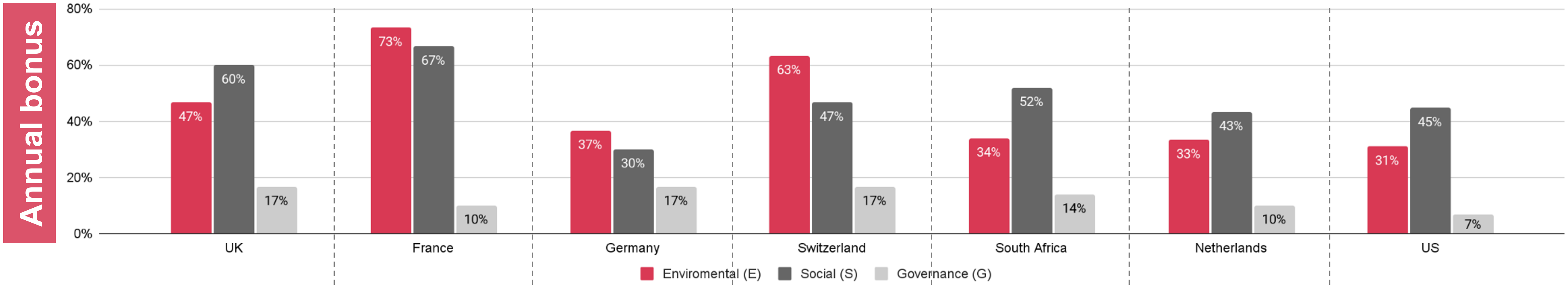
The majority of the largest companies in developed economies have adopted ESG measures into their incentives

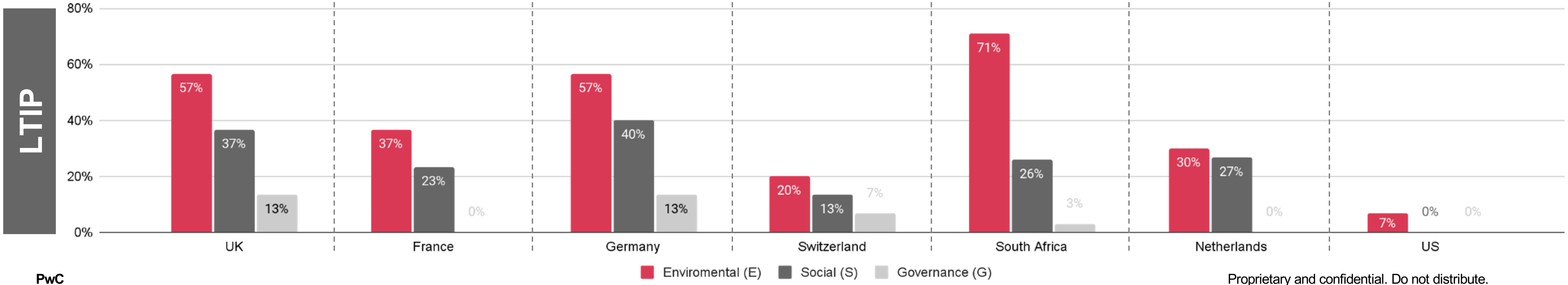
The chart below shows the percentage of companies that have adopted ESG measures in either their bonus or LTIP.



Environmental measures are generally the most commonly used ESG measure in developed economies

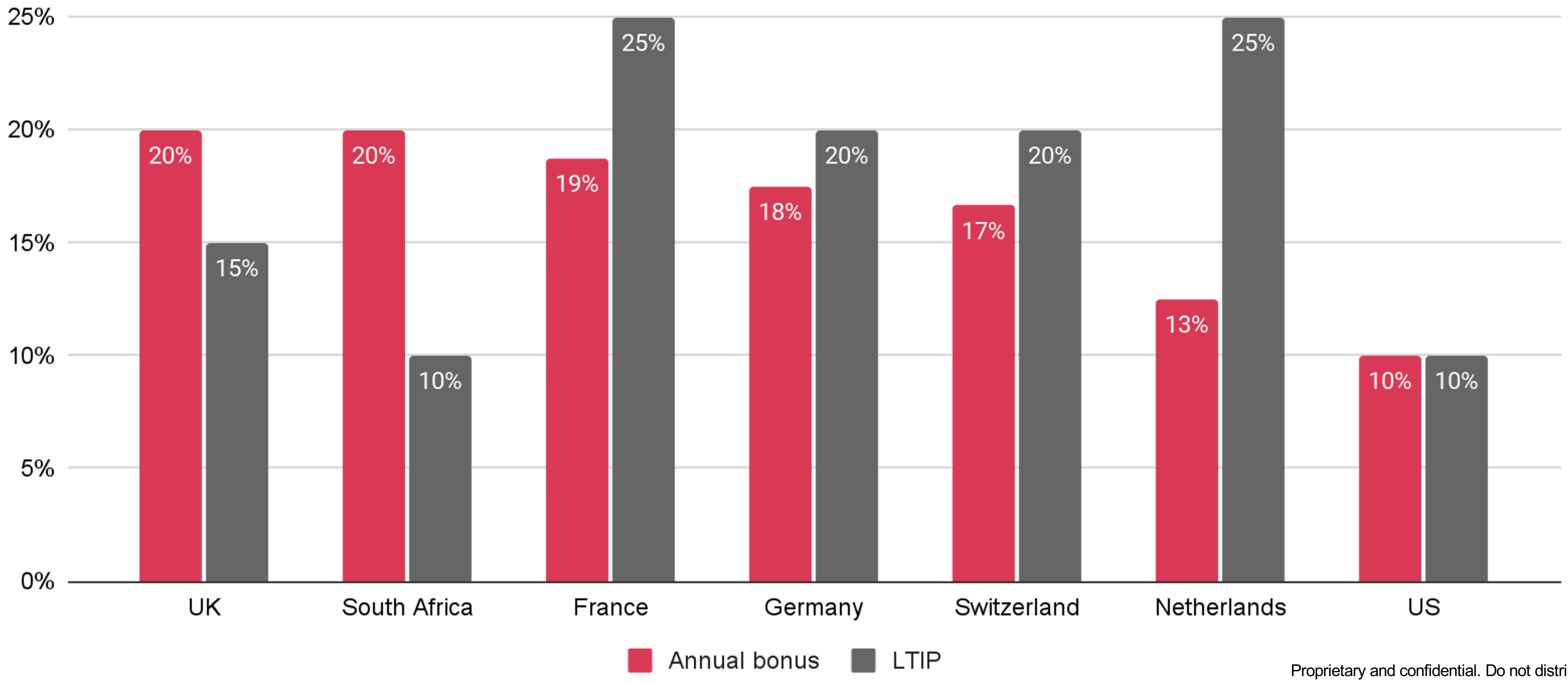
The chart below shows the use of ESG measures in the annual bonus and LTIP





The median weighting of ESG measures does not exceed 25% of the total pay element

The chart below shows the median weighting of ESG measures in the bonus and LTIP



Immediate future: More scrutiny on what is being measured and how.

1. Significant: a separate and meaningful percentage of incentives linked to pay

2. Measurable: objective and quantifiable targets

3. Transparent: externally clear and prospectively disclosed targets

4. Disclosed link to long-term carbon goals: clearly explained link between the pay targets and stated carbon strategic goals

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Medium term: focus, robustness and does ESG=BAU?

Environment

Diversity

Employee engagement

Other geographies catch up with UK over the next couple of years

Convergence on core ESG measures

Investor expectations likely to become more demanding (e.g. third party assurance)

Longer term, ESG could shift into core part of governance, no longer assessed in pay, or as an underpin

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