Corporate citizenship in a civil economy

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Many companies around the world have discovered they can benefit financially from integrating environmental, social and governance (ESG) targets in their daily operations and strategy. At the same time institutional investors are more aware of their role as responsible shareholders after the devastation left by the credit crisis. Some of them have taken up the challenge to create a civil economy, in which they act as engaged shareowners for all the world citizens who have money in a pension or mutual fund or life insurance.[ii] In this article I explore the possibilities how these two important economic agents together can create a more responsible capitalism.

Responsible capitalism. Karl Marx would say it is an oxymoron. Adam Smith would consider it a pleonasm, provided all the agents would act in their self interest as responsible citizens. His *Theory of Moral Sentiments*, published in 1759, *can* be seen as a 'how to be a good citizen' guide for the Homo Economicus. For the people of today responsible capitalism is a necessity. Without it they and future generations will suffer the consequences of irresponsible market behaviour and the inability of people to control their demand. The fishing industry has driven many fish species to almost extinction, but apart from some regulation and pressure from biologists and non governmental organisations, there is no one in the sector seems to take the long term view. But taking a long term view i.c. delaying the instant gratification of one's needs is difficult, not only for fishermen, as Stanford University psychology researcher Michael Mischel already demonstrated in a n a longitudinal study which began in the 1960s.[iii] He showed that if we are less greedy and are able to wait for our rewards, we do better in life.
In theory free markets work well in bringing supply and demand together at a certain price. If we believe that price is an efficient way of keeping demand in check when it would hurt society. But as Joseph Stiglitz already described in *Freefall* (2010) we have no real free markets anymore. Regulation, subsidies, externalities, cartels and monopolies are obstacles for a correct price tag. Not to mention how far business will go to get the lowest production costs as

possible, and loosing their responsibility as a good corporate citizen along the way. Adam Smith would have been very disappointed with their moral behaviour.

After the collapse of the communist system more than twenty years ago, it felt as if market economy had won the Cold War. We were confirmed in our conviction that only the freedom of capitalism could make us prosperous and thus happy. Together with the success of China as a socialist market economy, where the idea of freedom is synonymous with being able to buy whatever you like, we loosened the reigns of the financial markets and let the government privatise certain sectors that once belonged to the domain of the state. In the Netherlands those were public transport, energy, telecom, post and healthcare.

The goal behind privatisation and deregulation was to improve the services, lower the costs and stimulate innovation, because in the 1990's the state had become synonymous with bad service, high costs and lack of creativity. Where the deregulation in the financial markets let to, we have discovered the last three years.

Corporate citizenship

After a few years economies world wide started the large scale deregulation, an earlier slumbering business movement came alive in the early 1990's. Companies like Ben & Jerry's, the Body Shop, BSO/Origin and Van Melle (the maker of Mentos) were fed up with the 'business of business is business' ideology and made an effort to be an environment friendly and a more social firm.

A big push for corporate social responsibility (CSR) came in 1995 where Royal Dutch Shell lost the debate with Greenpeace in how to dispose of its Brent Spar, a North Sea oil storage and tanker loading buoy. Later that year the company was again in trouble when the environmentalist Ken Saro-Wiwa was hanged by the Nigerian government, because of his opposition to the privileges of oil companies in Ogoni-land. Those two major incidents were the starting point for Shell to improve its communication about its activities with the outside world and improving its performance on environmental, social and governance issues.

At that time also Nike and Monsanto were in trouble with the public and non governmental organisations. Nike because of child labour and Monsanto because of its genetic modified seeds and its selling methods.

The amazing thing is that although all three companies have improved their behaviour considerably, their reputation is still tarnished. 16 years later Nike, now almost a picture perfect example of a responsible company, is always mentioned in relation to child labour. With Monsanto and Shell the big elephant in the room is their core business. No matter how hard they try to be a responsible corporate citizen, the externalities of GM crops or the exploration and us e of oil and gas are something society as a whole has to deal with and share the costs of. Although the basis of corporate citizenship has always been the responsibility for the externalities of corporate behaviour and ways of decreasing or compensating them, we can see certain trends. From 1995 until 2002 most companies and institutional investors[iv] saw CSR as hype, something that would pass. John Elkington (1997) succeeded in laying the basis for a more professional approach with his description of the Triple Bottom Line consisting of the three performance measurements: people, planet and profit. He took the discussion away from ethics and reputation and showed that companies should start measuring the return on investment in better employee policies or energy efficiency. But the attention for corporate behaviour regarding people and planet got unexpected support from the sudden attention for corporate governance.

Business code, codes of conducts and the ethical dimension of business have always been an integral part of CSR, but corporate governance goes further than that. It contains also checks and balances for the relationship between executives, non-executives and supervisory boards, and the relationship of the company with shareholders. A corporate governance code contains for example guidelines for shareholders meetings, engagement and dialogue with listed companies.[v]

The wave of company scandals in 2001, Enron, Worldcom, Ahold, Parmalat to name a few, gave not only a big push for corporate governance codes around the world, it also increased the attention for corporate responsibilities. Not in the least because Enron had presented itself as a

sustainable and responsible company and was never challenged on that. It gave the lobby for more transparency and stricter guidelines en performance indicators a lift.

From 2002 onwards we see an increase of separate so called Corporate Social Responsibility reports in which companies try to be accountable for their social, environmental and ethical (SEE) efforts. In 1997 guidelines for these reports are developed by the Global Reporting Initiative (GRI), a multistakeholder organisation that has succeeded in becoming the norm for non financial reporting world wide. Some European countries, France, Sweden and Denmark have now legislation on non financial reporting and refer to the guidelines from the GRI. In the Netherlands non financial reporting is not mandatory but there is institutional pressure from the Dutch accounting standards board and the Social Economic Council to use a special accounting guideline for non financial reporting, the so called RJ 400.

With the publication of the Stern Review on the Economics of Climate Change in 2006 the jargon changes from corporate social responsibility to sustainability.[vi] Suddenly the use of energy, natural resources, innovation and the long term view of companies comes more into focus.

The attention for climate change led to the establishment of the Carbon Disclosure Project (CDP). In 2008, it published the data for 1550 of the world's largest corporations, accounting for 26% of global greenhouse gas emissions. Since the scandal surrounding the International Panel for Climate Change (IPCC), less people believe in the anthropogenic nature of climate change. But the opinion of the general public has had little effect on the efforts of companies and investors. Some 3,000 organizations in some 60 countries around the world now measure and disclose their greenhouse gas emissions and climate change strategies through CDP. Goal is to set reduction targets and make performance improvements. Since 2011 CDP has started with a similar project for the use of water.

The participation in the CDP and writing a sustainability report is not mandatory, but their popularity shows that companies are prepared to behave as a corporate citizen and make an effort to be accountable to other stakeholders of society. And although many companies are still struggling with disclosure of non financial or ESG performance, they discover that

transparency on sustainability is also in their self interest, because they discover vulnerabilities and risks that would otherwise remained under the surface.

The group of responsible corporate citizens is growing world wide, but slowly, we still have to deal with corporations that treat their employees and/or the environment very badly. Dubious social and environmental performance is often combined with bad corporate governance. But that does not mean that good governed companies have an eye for environmental and social risks, vice versa is more likely.

The institutional investors are partly responsible for this phenomenon. They were rather late in discovering the benefits of keeping an eye on risk appetite and risk management in relation to sustainability issues. Their focus in the last years have been mainly on corporate governance performance and then in particular on following the special corporate governance codes and rules of engagement. Boards' behaviour, or shall we say human misbehaviour through perverse financial stimuli, was not considered to be an important issue as long as financial returns were within or higher than expectations. But that attitude is changing. Not in the least through the trouble that oil company BP had in the Gulf of Mexico. Many British pension funds, and thus many British pensioners, lost a lot of money, because BP was not monitored thoroughly enough on its environmental and safety performance.

Citizen investors

In 'The New Capitalists' Davis, Lukomnik and Pitt-Watson (2006) show that in 1970 just a small group of wealthy individuals controlled corporations in the United States. And they really controlled them, as the financial institutions representing small investors owned only 19 percent of stock. Thirty years later, according to the American Conference Board, institutional investors owned 61.4 percent in the thousand largest public companies in the United States. In 2009 that percentage was 73.

That same picture applies for continental Europe. In 1995 institutional investors owned 22 percent of the listed companies in the Netherlands. That percentage increased to 84 in 2009. . The majority of the stocks of Dutch listed companies are owned by non Dutch investors; on the other hand Dutch institutional investors have a global diversified portfolio. As half of the

pension funds capital is invested in shares of listed companies and saving for a pension is mandatory for all Dutch employees we can without a doubt say that the average Dutch person is an international shareholder or as Davis (2006) calls this share ownership: a citizen investor. Eumedion was set up in 2006 to increase the cooperation between institutional investors with holding in Dutch listed companies to improve the corporate governance performance of listed companies. In practice that means encouragement of joint consultations between institutional investors and with listed companies and their representative organisations. But our purpose is also to safeguard and improve the interests of those investors in relation to corporate governance by influencing legislation and regulations. We do that through consultation with the Dutch government, institutions of the European Union, other relevant authorities and organisations.

Institutional investors invest directly or indirectly at the expense and risk of their ultimate beneficiaries, i.e. the persons entitled to a pension, the employees who pay pension contributions, the policy-holders, the participants in investment funds, et cetera. These investors must deal prudently, therefore, with the financial resources entrusted to them and must render account for their dealings. In principle this means that Institutional investors have a long-term investment philosophy. But such a philosophy is not synonymous with keeping shares in certain companies for the long term. An institutional investor can come into conflict with its responsibility for its clients, for example, if it continues to hold shares in a certain company while the market value of the company in question is much higher than the value of the company according to the investor, or when the company's strategy is no longer consistent with the institutional investor's investment strategy.[vii]

The credit crisis has shown that the human factor plays an important part in investment decisions, even though we have tried to make investing a value free process through the efficient market theory, mathematical models and the goal of maximising the rate of return in the long run. Some say that the people in the financial world lost their way through animal spirits, some lay the blame with perverse stimuli as bonuses and others think the credit crisis was just the result of laziness, incompetence and lack of common sense. My personal opinion is that we forgot the real economy. We can not make money with money, there has to be a real

underlying value. The value of money is trust. And trust can only grow if we have a fair and responsible society, wherein money is a tool to create a better world for current and future generations. Because of the credit crisis in the West a growing group of people have lost and are still losing their trust in the financial institutions. It is important to regain that trust, as a low trust society is more expensive than a high trust one.[viii]

The role money can play in regaining trust in the financial sector is by putting it to work for a better and fairer society without losing its ability to get a decent rate of return. What decent is can every investor decide for him- or herself. Through taking into account the effects on the natural and social environment and other externalities, maximising or optimising the rate of return will lead to a more decent outcome.

Investors and economists are always worried about the moral dimensions such an approach. But nothing in this world is value free. If we build a model, we always have to start with assumptions. If we decide that maximising profit is the best thing to do, then that goal has become our norm. In the last three years we have painfully felt the consequences of going for the highest return. But somehow we do not learn from those painful experiences, as Kenneth Rogoff and Carmen Reinhart have shown. (2008, 2009)

The tendency is to blame the bankers and the big investors for the credit crisis, but I think governments, supervisors and citizens are as much to blame. They also were blinded by Mammon, the idea that more money would mean a better society and more happiness. Greed has never been good because on the other side of greed is always a person less of. The next step in overcoming the credit crisis is to create a responsible financial sector and that can only happen if consumers (beneficiaries of pension funds, buyers of financial products like life insurance, mortgages et cetera), bankers, investors and companies take their different responsibilities and be accountable.

Prudence and responsibility

Risks and taking risks will always be part of life, but we can be more prudent financial consumers, managers, entrepreneurs and investors if we take more into account then only financial risks. As UNEPFI already showed (2005, 2009) that fiduciary duty requires considering

environmental, social and governance factors, at least were they are (potentially) material in their financial impact. ESG factors influence risk appetite and risk management, but taking them into account can create a wide range of opportunities as already a large group of investors and companies have discovered. A recent survey under CEO's by Accenture in 2010 showed that sustainability issues will be important or very important to the future risk a return profile of 93 percent of companies in the world.

225 asset owners and 493 investment managers have signed the UN Principles for Responsible Investment (UNPRI) and have committed themselves in that way to integrating ESG criteria across the investment processes and asset classes. A big step will be that all these signatories also start engaging with companies, on a board level, on these issues. But the biggest step will be if all institutional investors also attach consequences to their engagement, for example if certain corporations do no want to listen to the suggestions made by their shareholders. We have seen some examples. Dutch investor PGGM and the Norwegian government pension fund sold their stakes in the British/Indian mining company Vedanta Resources because of its human rights performance. The selling investors saw the attitude of the company as a potential financial risk. But these kinds of transactions are still an exemption. More and more companies, especially in developed markets, are sensitive to the pressure of investors and, at the same time, see themselves the advantages in being a responsible company.

To step up the efforts of institutional investors to engage more thoroughly with listed companies, the help of the real shareowners, the beneficiaries of life insurances and pensions, and the boards of the pension funds is needed. And for that education is essential. Because of the lack of interest and knowledge beneficiaries refrain from engaging with pension funds about their investment wishes. And the turmoil surrounding the financial performance of pension funds does not help in getting the message across that being a responsible and engaged investor contributes to a better financial performance. For the non believers in the added value of responsible investing Mercer (200) published an overview of approaches, returns and impacts. But as the experience of private equity shows: the time and effort one puts in a company and in the engagement with the board really pays off when both parties respect each other.

Incidents and media attention are currently the major drivers behind beneficiaries engagement. In 2007 Dutch pension funds were involved in a scandal surrounding investments in cluster bombs. Although not many beneficiaries wrote letters of complaint to their pension funds, there was a national outcry and many pension funds changed their investing policy.

Conclusion

Companies and investors have discovered the merit of looking broader to their activities and performances. Financial targets and identifying financial risks are no longer enough to satisfy the long term performance targets of institutional investors. Environmental, social and governance performance criteria have found their way into risk management and strategy of companies and investors. These changes take time to materialise and show financial results that can convince the traditional investors and conservative boards. Nevertheless the evidence is growing that taking ESG criteria into account and disclosing the results is benefiting companies and investors.

As these results become more mainstream, they can play an important role in regaining public trust in financial institutions and supervisory authorities. At the same time taking environmental, social and governance issues into account can create a fairer global economy in time, as respect for human rights, good labour conditions, adaptation to climate change and less environmental damage become part of the world wide decision process.

Governments, central banks, the United Nations and the institutions set up in Bretton Woods, the IMF and World Bank can play an important role in officially recognising that ESG performance of companies and investors really matter. Some countries and regulators are ready to apply ESG guidelines on their own behaviour and use them as decision criteria. Some economists are already predicting the next financial crisis. Increasing corporate citizenship in a civil economy, where financial regulators use their powers to stop bubble blowing when Mammon seduces the vulnerable, should keep us safe from destroying financial and non financial capital.

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[ii] In 'Maatschappelijk Ondernemen' (2001) roughly translated as 'Social Business' the term corporate citizenship is used as a description for companies that take environmental, social, governance and ethical criteria into account in their daily operations and strategy. By doing business in such a way they diminish and/or compensate their externalities. The term 'civil economy' in this investment context is from the book 'The New Capitalists, how citizen investors are reshaping the corporate agenda' by Stephen Davies, Jon Lukomnik and David Pitt-Watson (2006).
[iii] Starting in the late 1960, a Stanford University researcher Walter Mischel conducted a long-term study. Mischel arranged individual marshmallows in front of hungry 4-year-old children. He subsequently informed them they could have 1 marshmallow immediately, or if they wait several minutes, they could have 2. Some children quickly took the single marshmallow and ate it up. Other children waited. Mischel surveyed the group 14 years later and found out that the children who eagerly consumed the first marshmallow were more vulnerable as compared to the children who had paced themselves for 2 marshmallows. The patient children possessed better coping skills, were more socially aware, optimistic, assertive, reliable, and scored nearly 210 points higher on their SATs.
[iv] In this paper institutional investors are defined as pension funds, asset managers, managers of investment institutions and insurance companies who invest in an old fashioned way, in the sense that they do not generally go short (i.e. long only), and do not pursue an event-driven strategy.
[v] There are many definitions for corporate governance. A company's governance comprises the set of structures that provide boundaries for its operations. This set of structures includes participants in corporate activities, such as managers, workers, suppliers, society, shareholders; the returns to those participants; and the constraints under which they operate.
[vi] Corporate Social Responsibility and sustainability are synonymous. Nowadays the term sustainability is more widely used. Sustainability or CSR issues include climate change, energy and natural resources efficiency, human rights, community relations, labour standards, biodiversity and water and how these factors are managed across the value and supply chain. The term ESG (environment, social and governance) is broader because it also takes into account corporate governance issues, like relation with shareholders, remuneration, disclosure and risk management.
[vii] In March 2010 Eumedion published a position paper Engaged Shareholdership, in which the attitude, behavior and responsibilities of its participants is described.
[viii] As Francis Fukuyama and Robert Putnam explain in their books and articles.