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Beyond economic sustainability: embedding social and environmental values in the governance of responsible investment.

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Abstract

The transition of global financial markets towards investment models that incorporate environmental and social dimensions is now well underway. This paper discusses the evolution of contemporary responsible investment (RI) and its relationship to sustainable development and environmental social governance (ESG). In the conception of ESG presented here, various well-known institutional arrangements, most notably interest representation, accountability and transparency, decision-making, and implementation are linked to the structures and processes of governance. Using a hierarchical framework of principles, criteria and indicators (PC&I), the paper presents a means for evaluating RI by way of an analysis of stakeholder perceptions regarding the sector's governance quality. It concludes with some observations on the challenges confronting RI, notably the need for universally consistent quality of governance standards.

Introduction

Since the UN Conference on Environment and Development (UNCED – 1992), sustainable development has been promoted through a range of global public-private initiatives, including the Global Compact (2000). UNCED played a central role in the development and promotion voluntary methods of environmental problem solving as an alternative to governmental regulation (Clapp 2005). These are implemented through a range of private sector, market-based mechanisms such as emissions trading and eco-labelling (Jordan et al 2005; Falkner 2003) whereby a range of actors, state, civic and business have

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come together in a series of multi-scalar, multi-stakeholder initiatives (MSIs), "conducive to inclusive development" (Utting and Marques 2010, p. 17).

In 1999, the World Bank and the Organization for Economic Co-operation and Development (OECD) co-founded the Global Corporate Governance Forum (GCGF) as a facility of the International Finance Corporation (IFC). The aim of the Forum is to encourage companies to invest, and behave, in a socially responsible manner (GCGF 2010). Between 2003 and 2005 the United Nations Environment Programme Finance Initiative (UNEP FI) engaged in a process with the UN Global Compact and investment industry representatives to develop a set of principles for responsible investment (PRI) (Global Compact and UNEP FI 2009a). The PRI initiative is aimed at integrating ESG issues into financial management (Global Compact and UNEP FI 2009b). These cover elements required for reporting on environmental and social performance, referred to as sustainability reporting (UNEP FI 2009e). Sustainability reporting functions within a context of transparency about economic, environmental, and social impacts and is a "fundamental component in effective stakeholder relations, investment decisions, and other market relations" (GRI 2008, p. 1). These elements were identified and developed between 2003 and 2005 in collaboration with the Global Reporting Initiative (GRI), and building on the 2002 social performance indicators of SPI Finance. Environmental reporting concerns a number of elements, including materials, energy, water, biodiversity, emissions, compliance and transport. Social reporting covers four sub-themes: labour and work practices, human rights, society, and product responsibility. Economic reporting is also included and concerns such issues as financial performance, market presence, indirect economic impacts, and investment in the community. Each of these activities is reported against a series of performance indicators (GRI 2008). Such initiatives are to be understood as examples of 'soft' law, based around "aspirational voluntary declarations of intent" (UNEP FI 2009d). Here, compliance occurs in the context of self-regulation against standards, which concern such areas of corporate activity as accountability, responsibility and implementation (Clapp 2005).

As a financial sector, RI is governed by a plethora of initiatives that have arisen in the absence of any formal global system. There are a variety of models

to determine social and environmental sustainability and there is clearly a need for some level of consolidation (Waddock 2008). Despite the proliferation of such systems of private environmental governance, there are no consistent rules or standards to guide them (Whitman 2005). The problem of competing approaches to evaluating sustainability is evident in the RI sector. In the case of screening for example, there is an evolving debate over which method is preferable: some companies use negative screens (no alcohol, tobacco, firearms); others screen positively (best-in-class); others simply on the basis of the degree to which a company engages and involves multi-stakeholders (UNEP FI and Mercer 2007). The result is that there is uncertainty regarding the legitimacy of both the evaluation methods being used and the entities being evaluated.

Analytical perspective

In view of the developments discussed above, this paper conceives 'stakeholders' as a group of diverse interests that collectively shape the institutions in which they interact, allowing for a more integrative conception than allowed for in more strictly neo-utilitarian theory. MSIs are also made up of a wide range of actors, from civil society to more traditional interests, which inter-subjectively shape and share ideas about institutional structures and processes. Such developments require new approaches to evaluating the frameworks through which governance is legitimated. On this view, universal ownership is extended to include interests traditionally seen as peripheral to business practice. By understanding governance as being founded on stakeholder engagement in the broadest possible sense, responsibility can be evaluated in environmental and social as well as economic terms, resulting in a transition away from traditional practices of corporate governance. This allows for a more ethical, and less functionalist model for determining governance quality (Ruggie 1998). Traditional economic preferences for maximising shareholder returns are now being increasingly supplemented by broader concerns about ESG (Hawley and Williams 2005).

Contemporary ESG can be traced back to the recognition that modern corporate governance consists of "mechanisms to reach collective decisions about transnational problems with or without government participation" (Haufler

2001, p. 1). Rather than looking solely at the imposition of various externalities on global or regional economies by corporations, it is also possible to look at the external imposition of a range of obligations/pressures on corporations by transnational advocacy groups, or networks including NGOs (Keck and Sikkink 1998). These have led to corporate responses that have resulted in a 'greening up' of transnational corporations and financial institutions, such as the World Bank (Haufler 1999; Park 2007). RI consequently reflects the trends found across the field of sustainable development whereby non-government organisations (NGOs), stakeholders and other market-based actors are interacting within governance systems that have a wider focus than those found in traditional 'top-down' institutions. This more collaborative approach generates new partnerships between businesses, NGOs and governments, and creates new services and products (GGCF and IFC undated). It is now possible to speak of a 'new corporate governance', which reflects the norms of contemporary governance theory including an orientation around such environmentally and socially-oriented values (Hilb 2009).

Four main issue areas impinge on the growing understanding of contemporary governance. The foremost without doubt concerns responsible organisational behaviour (or corporate social responsibility), usually understood in terms of accountability and transparency (Garten 1999; Hawley and Williams 2005; Detomasi 2006; Waddock 2008; UNGC and GCGF 2009). A second and almost equally significant area of concern is around the representation of different stakeholder interests within a given institution. Here the discussion is largely about issues of inclusiveness and equality, particularly whether all interests enjoy the same levels of access and weight as economic interests, and similar degrees of institutional or technical capacity to participate effectively (Jänicke 1992; Stiglitz 2003; Kerwer 2006; Koenig-Archibugi 2006; GGCF and IFC undated). A third concern is centred upon decision-making, notably the presence or absence of institutional democracy, methods by which agreements are reached, and how disputes are settled; in the case of corporate governance, such issues as having a 'say on pay' are especially relevant. (Ostrom 1990; van Vliet 1993; Jänicke 1996; Meidinger 2006, Bebchuk and Hamdani 2009). The fourth major preoccupation is the manner in which policies, programmes or standards are

implemented. In the domain of sustainability, effective implementation has been identified as relating to both the behavioural- and problem solving abilities of an institution (Skjærseth et al 2006). In the context of RI, behavioural change would refer specifically to changing behaviour around financial market activities that result in environmentally and socially unsustainable outcomes. The problem RI is seeking to address is the negative externalities associated with unsustainable investment (e.g. deforestation). Given the inherently dynamic nature of the ecological systems (and related markets), such institutions also need to be resilient in the face of changing external circumstances, such as climate change, or market conditions. Non-resilient systems are unlikely to remain durable in the light of such changes (Folke et al 2005). Durability in the context of RI would refer to long-term investment practices that are based on environmentally and socially sustainable practices.

These various governance arrangements can be brought together into a hierarchically consistent framework of principles, criteria and indicators (PC&I), which allows for the evaluation of RI as a mechanism of sustainable development. The relationship between principles, criteria and indicators, and how the various elements discussed above can be formulated for assessing the governance quality of RI, are laid out in Table 1 below. A principle is a fundamental rule, perspective, or value, which serves as a basis for determining the function of a complete system in respect to explicit elements. Criteria function at the next level down, and can be described as categories of conditions or processes, which contribute to the overall principle. They are intended to facilitate the assessment of principles that would otherwise be ideational and non-measurable. Criteria are not usually capable of being measured directly, but are formulated to provide a determination on levels of compliance. They are consequently linked to indicators, which are hierarchically lower, and which represent quantitative or qualitative parameters that relate to the relevant criterion Together, PC&I may be used as the basis for standards, which serve as a reference for monitoring, reporting and evaluation. (Lammerts van Beuren and Blom 1997). Standards determine how the substantive outcomes of a given system are formulated and applied, thereby delivering effectiveness and legitimacy (Kooiman 1993).

Table 1: Hierarchical framework for evaluating the governance quality of RI

Principle	Criterion	Indicator
"Environmentally and socially sustainable investment"	Organisational responsibility	Accountability
		Transparency
	Interest representation	Inclusiveness
		Equality
		Capacity
	Decision-making	Democracy
		Agreement
		Dispute settlement
	Implementation	Problem solving
		Behavioural change
		Durability

Source: Cadman 2009 (adapted)

Methodology

Using the analytical perspective outlined above, a survey of stakeholders associated with RI was developed to provide some insight into attitudes concerning the governance quality of RI amongst some of the participants in the sector. In late 2009-early 2010 the author contacted various institutions, which were invited to fill in an anonymous survey asking them to rate the governance quality of the RI sector, on the basis of the eleven indicators of Table 1.[2] A wide range of stakeholders was invited to participate from across the RI constellation. Selected target groups comprised academia, awards and prizes, listed companies, conferences and events, financial institutions, governmental organisations (national, regional and international), indices, media, NGOs, professional associations, public private partnerships, rating agencies, and researchers. One

[2] The author wishes to acknowledge Dr Enrico Bernardini, portfolio analyst at the Risk Management Department of Banca d'Italia, for his invaluable assistance in compiling the database of target organisations.

the basis of who responded, and in order to make analysis tractable, survey participants were broken down into six groups: fund managers, financial planners and advisers, RI programmes, NGOs and researchers; sole respondents were grouped under 'other' (bank, ethical shareholder, higher education, private investor, third party, responsible investment association). Table two lists the type, response count and number of survey participants.

Table 2: RI survey list of participants

Type	Number	Percent
Fund manager	7	25%
Financial planner and/or adviser	5	17.9%
RI programme	4	14.3%
NGO	3	10.7%
Researcher	3	10.7%
Other (Bank, Ethical shareholder, Higher education, Private investor, Third party, Responsible investment association)	6	21.4%
Total	**28**	**100**

Participants were asked by means of the Internet tool SurveyMonkey (www.surveymonkey.com) to rate each of the 11 indicators listed in Table 1 above, using a Likert scale from 'very high' to 'very low'. A 'don't know' option of zero value was also provided; it is noted that this results in some statistical bias towards participants who expressed a preference. Questions were weighted to produce an average rating by group. The Table below presents a breakdown of results by group as well as an overall average across groups. This average figure allows for the aggregation of indicator scores at the criterion level and thus producing a total score, or 'consensus rating' across participants of the extent to which the principle of environmentally and socially sustainable investment is met by the RI sector.

Table 3: Responsible investment governance survey – participants' evaluation by criterion and associated indicators

	Highest possible score: 15 Average score: **9.03**			Highest possible score: 10 Average score: **6.31**		Sub-total (out of 25): **15.34**
Indicator	**Inclusiveness**	**Equality**	**Resources**	**Accountability**	**Transparency**	
Fund manager	3.14	2.86	3.67	3.00	3.43	
Financial planner/adviser	3.20	2.50	3.67	3.40	3.40	
RI programme	3.75	3.50	3.75	3.75	3.75	
NGO	3.33	2.67	3.00	3.33	3.67	
Researcher	3.33	1.67	2.00	2.00	2.33	
Other	3.17	2.80	2.25	3.00	2.83	
Average	**3.32**	**2.66**	**3.05**	**3.08**	**3.23**	

	Highest possible score: 15 Average score: **10.02**			Highest possible score: 15 Average score: **10.34**			Sub-total (out of 30): **20.36**
Indicator	**Democracy**	**Agreement**	**Dispute settlement**	**Behaviour change**	**Problem solving**	**Durability**	
Fund manager	3.33	3.60	3.60	3.43	3.29	4.00	
Financial planner/adviser	3.67	3.67	3.50	3.80	3.40	4.00	
RI programme	3.25	3.50	3.75	3.75	3.00	3.75	
NGO	3.00	3.00	3.00	3.33	3.00	3.67	
Researcher	3.00	3.50	3.00	3.00	3.33	3.33	
Other	3.33	3.00	3.50	3.60	3.50	3.17	
Average	**3.26**	**3.37**	**3.39**	**3.48**	**3.25**	**3.61**	
Rating (out of 55)							**35.70**

Discussion

Given the small number of respondents (28), and the preponderance of Australians and New Zealanders (16) the study should be seen as largely anecdotal and merely indicative of *some* of the viewpoints within the sector, rather than being in any way broadly representative or authoritative. Nevertheless, it reveals some interesting perspectives. Overall, participant attitudes were generally favourable. With a rating of 35.7 or 65%, it could be

said that the RI sector was perceived to have a creditable degree of compliance with the principle of environmentally and social sustainable investment. This would imply that there was a degree of confidence amongst survey participants in the structures and processes of governance across the sector. Below is a discussion, based on participants' comments, of some of the most salient features of the survey.

At the criterion level, interest representation performed relatively well, with a score of 9.03, or 60%. Both of the lowest scoring of all the indicators – equality at 2.66 and resources at 3.05, placing them both in the 'medium' band – are located under this criterion, however. In the case of equality, RI might be reflecting trends across corporate governance for domination by controlling interests and/or majority shareholders (Bebchuk and Hamdani 2009). As one survey participant bluntly commented, "Nobody treats all interests equally, and nobody should". This sentiment is also reflected in a comment made by a fund manager regarding the democracy of RI, which is worth inserting at this point:

> It is difficult to achieve democracy in RI systems, as they need to ensure a consistent process is followed. I don't think that democracy is a significant issue for RI investors. They only want to ensure that their money is being managed in a manner consistent to how they were told it would be managed.

While these observations may be true for certain controlling interests, major fund managers or other influential actors, this perspective might not sit well with stakeholders more peripheral to the institutional centres, but affected by its activities, such as Indigenous People, or local communities. The availability, or provision of resources (technical, institutional, financial) to participate in RI was the second weakest indicator at 3.05. Researchers selected 'low', whilst fund managers, financial planners and RI programme all selected 'high'. Here it might

be concluded that these interests, located as they are at the centre of RI, would have the necessary infrastructure to participate effectively in RI. An individual private investor, or third party, by contrast, might not. One researcher expressed the view that RI programmes tended to be "resource starved"; this was especially the case for "dedicated" ones (defined elsewhere by the another respondent as "genuine ethical and sustainable fund managers"). Whether this is a comment on the level of resources provided to RI programmes within existing financial institutions, or on the difficulty for independent, more stringent RI programmes to attract the necessary support, or both, is unclear.

Mitigating these indicators is inclusiveness, which achieved a score of 3.32. Most respondents selected medium (16) or high (7), reflecting a general view that programmes tried to be inclusive, at least in terms of the different market contexts in which RI could be applied. They were less sure about how much this aligned with what the "people on the street" wanted. Other negative comments included concerns about the narrowness of focus, including an overemphasis on the use of "outdated" methods such as negative screening, or restricted definitions of sustainability, which overly concentrated on governance risks.

With an overall score of 6.31, or 63%, the criterion of organisational responsibility achieved an acceptable, but not particularly inspiring, result. What is perhaps more alarming is the relatively low score for accountability (3.08); fund managers as a group scored it even lower (3.00). One made the comment that although investors wanted to be "part of the dialogue about the RI investment process" they often had to deal with fund managers who were often part of large, conservative and mainstream banks, which were not particularly responsive to these demands. Consequently, fund managers tended to keep

information to themselves, and this had knock-on transparency-related effects. As a result, these kinds of RI programme neither comprehensively disclosed their investment methodologies about the actual investments made, nor the reasons behind each investment. This was creating a sense of mistrust in the public. One researcher commented that they did not think a whole lot of attention was paid to accountability in the RI sector, and efforts at improvement had not gone very far. They expressed the view that the RI sector did not appear to perceive low levels of accountability as “major issue for the field, or at least a major barrier to expansion and mainstreaming”. Another researcher felt that there needed to be more accountability and monitoring of RI activity of institutions, so that investors could make clearer distinctions between those fund managers that were genuinely committed to RI and those that just paid it lip service. In this regard UNPRI needed more enforcement capacity. This comparatively low evaluation of such a core attribute of ESG is worrying, even if it is anecdotal.

Comments regarding the criterion of decision making – the individual indicator of democracy notwithstanding – were generally positive, resulting in an overall score of 10.2 or 68%. Most respondents selected ‘high’ or ‘medium’ for all three indicators, but there was a significant proportion, which selected ‘don’t know’, making it difficult to say that the scores in the Table 3 are particularly representative of survey participants. Whether this reflects a lack of knowledge, or interest, in these aspects of RI governance is unknown. One fund manager felt that “most decision making processes [were] fundamentally sound - in terms of being a good process to make consistent decisions”. Participants who commented about democracy, reflecting the trends in corporate governance noted above, sought to qualify the institutional expression of democracy in RI in some way.

One financial planner commented that: “No business enterprise can be operated in a totally democratic way and prosper as a business. But to the extent that RI institutions welcome and consider input from various constituent groups, I would rate them high”. One researcher didn’t see democracy as being “relevant to most firm structures, which engage employees fairly well in this space, but are not cooperatives etc.”. In terms of how agreements were made in the sector, another researcher made the comment that “people get to consensus pretty well in the RI space”. No survey participants commented on dispute settlement in RI; this had the highest level of ‘don’t know’ answers of any question in the survey (46%). Again, however, most opted for ‘medium’ (7) or ‘high’; two selected ‘very high’, and one ‘low’.

With a score of 10.34 or 69%, implementation was the (marginally) highest scoring criterion. The highest scoring indicators were located here: durability, at 3.61 and behaviour change, at 3.48. This would appear to indicate that survey participants were mostly optimistic about the resilience of RI, and its capacity to change investment behaviour now and into the future. In terms of durability, most respondents (16) would probably agree with the comment from one of the NGO representatives that RI was “experiencing strong and consistent growth”, although one researcher felt that the jury was still out over the future of the sector. One fund manager commented that RI would “be a lasting trend in the mainstream wealth management industry - if only because it addresses business risks and opportunities such as climate change”. The most detailed responses in the survey were made concerning RI’s influence on behaviour change. One NGO response sums up these sentiments:

> There is considerable anecdotal evidence that serious shareholder engagement programmes of the likes of Hermes, F&C and Regnan and

> others do indeed improve corporate behaviour… Also, whose behaviour is important to change? The investors, or the actual companies causing the damage? Changing investor behaviour in terms of 'considering' ESG factors is irrelevant if it does not send signals to the companies causing the damage on the ground. So called 'ethical funds' that only screen, but do not engage, have no impact on the world whatsoever, yet claim to be responsible investors. In any discussion of what is a responsible investor, the focus needs to be on the actual impacts on the ground of the actions of that investor, not on some notional assessment of whether the companies they hold happen to be more or less responsible companies. You can hold a portfolio of responsible companies in a large, liquid, relatively efficient market and make no difference to anything whatsoever.

The problem of 'greenwashing' that these observations imply, was raised by other respondents in various forms. One respondent from the 'other' group felt that:

> RI products have become increasingly important to corporate entities involved in irresponsible and unsustainable activities. They are part of a complex web of drivers [that] have become more important as the entities understand more about their power.

Another commentator from this group noted that part of the problem associated with RI's capacity to drive genuine behaviour change arose largely from the:

> The principle, that fund trustees must first and foremost make a profit this year [which] makes them timid, concerned only for the short term. The system favours the status quo, rather than courageous leaps into 'riskier' new areas, which we know we must invest in if this world is to be passed on in habitable form.

One financial planner provided a contrast to his kind of 'timid' approach. A more 'activist' institution, in their opinion, had a much greater capacity to change behaviour:

> RI institutions that are actively engaged in dialog with the companies in which they invest, and that use their power as shareholder to vote proxies and file proxy resolutions when necessary, can be very effective in changing the behaviour of corporations, in a 'trim-tab' sense. However, RI institutions can be much MORE effective when working in concert with NGOs, using the media to bring pressure to bear, and getting broad coalitions of investors involved in the effort.

RI’s contribution to problem solving was the weakest of all three indicators associated with the implementation. Participants from across the survey groups did however point to specific examples where RI had made an important contribution to sustainable investment practices. Commercial property development was a good example. Many large property funds now had a focus on owing energy efficient buildings, which was pushing these assets up in value. The weight of this money was devaluing unsustainable property. Another respondent felt that many RI programmes actively contributing to the development of solutions to the problems of irresponsible and unsustainable development. Although some programmes were operating in the RI space because they had merely identified a new business opportunity, they were still acting as “change agents”, even if they did not (yet) understand the importance of their role. Other participants acknowledged the important role RI was playing in changing behaviour, but they were less optimistic about the real impact on the ground.

As a general concluding observation, it is interesting to note that most stakeholder groups were fairly similar in the ratings they provided each of the individual indicators, with the exception of research-related participants, who were much more cautious, selecting ‘very low’ for equality (1.67), and ‘low’ for resources (2.00), accountability (2.00) and only rating transparency at 2.33. It is possible that the role of researcher affords these individuals a greater level of detachment, and possibly more objectivity, than other RI interests. In this case, it might be useful to pay more attention to the observations of this group in future studies of the RI sector.

Conclusions

Since UNCED, PC&I have become a primary means by which the effectiveness of sustainable development is evaluated in the field, and the basis for accreditation in the market. The advantage of the framework presented here for analysing ESG over existing methods of assessment, which emphasis single criteria (e.g. accountability), or emphasise only E, S, or G (or combinations thereof) is that it establishes a strong hierarchical logic between all the elements commonly identified as pertaining to the effective governance of sustainable development. The value of the PC&I approach to evaluation is that it also allows for the creation of standards that can serve as a reference for monitoring, assessment and reporting. It would be entirely possible to develop a standard out of the framework used in this study that could be applied to the practice of RI at the global, national and local levels. Such standards would bring the RI sector closer to realising its stated market objective to "identify, promote, and realise the adoption of best environmental and sustainability practice at all levels of financial institution operations" (UNEP FI undated, p. 3). As the world comes to grips with a range of global problems, and social political interactions increasingly shift to non-state contexts, governance standards are likely to become the main means by which legitimacy can be guaranteed. Such standards will make it easier for potential participants to determine whether they should engage in a given process or not. It will avoid the uncertainty that currently exists over the credibility of a given programme, and whether to lend it legitimacy by participating.

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