UNEP Finance Initiative
Innovative financing for sustainability

CEObriefing

The Materiality of Social, Environmental and Corporate Governance Issues to Equity Pricing

"It is becoming increasingly clear that sustainable development will be one of the major drivers of industrial change over the next fifty years and that there is a growing demand from both companies and institutional investors to understand its financial impacts."

Colin Monks
Head of European Equity Research, HSBC

11 Sector Studies by Brokerage House Analysts at the Request of the UNEP Finance Initiative Asset Management Working Group

Background from the AMWG Chairs

"Our engagement in this project has strengthened Storebrand's conviction that Environmental, Social and Corporate Governance issues must increasingly feature in the activities of corporate leaders."

Idar Kreutzer
CEO, Storebrand

An increasing number of institutional investors are becoming interested in approaches to asset management that explicitly include environmental, social and corporate governance criteria or metrics, either for ethical reasons or where they are or may become relevant to investment performance.

While there are increasing pressures for investment managers to address these issues, however, they have generally received little consideration from brokerage house analysts and policy-makers.

The twelve members of our group, along with many other large financial institutions worldwide, have signed or are considering signing a United Nations Environment Programme declaration that pledges us to integrate these issues into our products and operations.

In April 2003 in response to investor demand and in fulfilment of our obligations as signatories to this pledge we constituted an Asset Management Working Group (AMWG) within the United Nations Environment Programme Finance Initiative (UNEP FI) to explore and document the materiality of environmental, social and corporate governance considerations and criteria as they relate to the portfolio management of mutual and other institutional funds.

From August to October of 2003 we invited more than 50 major stock brokerage firms with whom we do a significant amount of business to be responsive to our request for an analysis of seven industry sectors as defined by Morgan Stanley Capital International (see project timeline).

The analysts were requested to identify specific environmental and social criteria likely to be material for company competitiveness and reputation in those sectors. We also asked the analysts to the extent possible to quantify their potential impact on stock price.

Project Timeline

1. **April 2003: Launch**
   - Twelve Asset management firms launch an asset management working group under UNEP FI to explore and document the materiality of environmental and social considerations and criteria as they relate to the portfolio management of mutual funds, pension funds and other institutional funds.
2. **May–September 2003: Planning and Invitation**
   - Identify the heads of research and brokerage house analysts from more than 50 brokerage houses with whom the group does significant business.
   - Agree on and send a letter to the above firms requesting special sector reports (without financial compensation) on extra financial issues in seven sectors.
3. **October–December 2003: Response**
   - 14 reports from 11 firms confirmed.
4. **January – April 2004: Broker Research**
   - Four reports withdrawn from project.
   - One report added.
   - One sector changes from apparel to aviation.
5. **May – June 2004: Comment and Analysis**
   - Final output: 11 brokerage house analyst reports.
   - Group compiles comments on reports.
   - Results compiled in collaboration with the UN Global Compact.
6. **June 2004: Launch**
   - At UN Global Compact Leaders Summit

Asset Management Working Group Member Firms

- Acuity Investment Management, Canada
- BNP Paribas Asset Management, France
- Calvert Group Ltd., USA
- Citigroup Asset Management, USA
- Groupama Asset Management, France
- Morley Fund Management, UK
- Nikko Asset Management, Japan
- Old Mutual Asset Managers, South Africa
- San Paolo IMI Asset Management, Italy
- Storebrand Investments, Norway
- ABN AMRO Asset Management, Brazil
- HSBC Asset Management, Europe

"This project clearly indicates that companies that treat governance and sustainability issues with importance are better positioned to deliver long-term, sustainable value to their shareholders."

Barbara J. Krumsiek
President & CEO, Calvert

By April 2004 we had received 11 reports from 9 brokerage houses. The results of the research were telling:

- There was agreement that environmental, social and corporate governance issues affect long-term shareholder value. In some cases those effects may be profound.
- The majority of analysts noted difficulties in comparative analysis due to the range of reporting practices for environmental, social and corporate governance risks and opportunities.
- Financial research was greatly aided by clear government positions with respect to environmental, social and corporate governance issues. In some cases analysts were not able to provide in-depth reports due to a lack of certainty regarding government policy.

These results provide strong independent support for the thesis that effective management of these issues will contribute to growing shareholder value. We therefore feel that they should be taken into account in fundamental financial analysis and thus investment considerations. In light of these findings:

We urge corporate managers and board directors:
- To include environmental, social and corporate governance reporting in their annual reports and financial statements.
- To urge the trustees of their employee pension funds to invest pension fund assets in a manner that reflects the strong links between social, environmental and financial performance.

We also urge governments to:
- Recognise that in general, current definitions of trustee fiduciary duty, financial materiality and corporate disclosure requirements do not incorporate or ensure the integration of environmental, social and corporate governance issues into fundamental company analysis.
- Ensure that the assets of their public employee pension funds are invested in a manner that reflects the strong links between social, environmental and financial performance.

We therefore call on regulatory bodies to:
- Update their regulations of public and private trustee fiduciary duty and of financial materiality to include consideration of material environmental, social and corporate governance issues.
- Update financial disclosure regulations for companies and stock exchanges to require specific disclosure of environmental, social and corporate governance criteria.

Based on our own experience and the results of this research we see environmental, social and corporate governance issues as being an integral part of successful management in the modern World. We therefore strongly feel that they should be taken into account in financial analysis and in investment management.

Starting in 2004 our group is planning to begin tracking global integration of environmental, social and corporate governance criteria into the work of investors, asset managers and capital markets on an annual basis. We will do this using a ten-point list of indicators described in the upcoming activities section of this report.

These indicators are based on both the results of the broker research, our own experience and on the recommendations of the UN Global Compact high-level initiative on best practice in financial analysis.

Sincerely,

Carlos Joly
Co-Chair:
UNEP FI Asset Management Working Group
Advisor to the CEO
Storebrand Investments, Norway

Vincent Zeller
Co-Chair:
UNEP FI Asset Management Working Group
General Manager and Chief Investment Officer
Groupama Asset Management, France

Project findings

"We strongly believe in full and consistent disclosure of CSR data by companies so that they can be included in fundamental company analysis, where we believe that they belong."

Anthony Ling
Co-Director of Research,
Goldman Sachs Europe

1 Environmental, social and corporate governance criteria affect shareholder value both in the short and long term.

- Analysts agreed that environmental, social and corporate governance criteria impact both positively and negatively on long-term shareholder value. In some cases these effects may be profound. It follows that research to determine the financial materiality of these criteria should use longer time spans than is currently the norm for financial analysis.

2 Governments can reduce barriers to environmental, social and corporate governance analysis by mandating and standardising the inclusion of these criteria in national and international financial disclosure frameworks.

- Most reports and AMWG members agreed that financial analysis of these criteria would be made easier if governments, via their financial regulators, clarify and/or enforce existing or develop new financial disclosure regulations and standards to specifically include disclosure of these criteria where they have been shown to be material.
- Definitions of fiduciary duty and financial materiality within these frameworks should also be revised to incorporate consideration of environmental, social and corporate governance criteria.
- The Global Reporting Initiative should ensure that its reporting guidelines are relevant for and communicated to the financial community and financial regulators.

3 Innovative techniques are being developed to perform financial analyses of environmental, social and corporate governance criteria in response to growing investor demand.

Examples include:

- **Surveys**

Surveys were used to gather information on and rank company performance for environmental, social and corporate governance criteria not normally disclosed in company financial statements.
It is possible that no set of financial indicators would show any link to performance if analysed using a small number of companies. We therefore encourage analysts to use larger numbers of companies when performing analysis of this nature.
Examples:

Goldman Sachs Global Energy Research
Introducing the Goldman Sachs Energy Environmental and Social Index

West LB Equity Markets Pan-European Equities
Insurance and Sustainability: Playing with Fire

- **Portfolio analysis**

The best analyses used financial metrics to compare best from worst performers for a given set of environmental social and corporate governance criteria against existing stock portfolios. The comparison helped analysts evaluate the financial impact of chosen criteria for a given industry sector. This is an important step beyond identifying potential criteria for analysis and determining best and worst performers.
Example:

Deutsche Bank Global Equity Research
Beyond the Numbers: Corporate Governance: Implication for Investors

Scenario analysis

Analysts used scenario analysis to evaluate potential impacts of upcoming regulation on companies. This analysis was also used when government positions on a particular environmental, social and corporate governance issue were clearly articulated policy or position papers.

Example:

UBS Global Equity Research

European Emissions Trading Scheme - Bonanza or Bust?

"Deutsche Bank Equity Research team believes that corporate governance is a critical element of equity risk and as such, deserves to be measured and considered in the investment decision-making process."

Russell Duckworth

Global Head of Equity Research, Deutsche Bank

4 Brokerage houses in the European Union are increasingly willing and able to respond to demand for environmental, social and corporate governance research.

We received a 20% response rate to our invitation to provide this research. In the future we expect that growing awareness of the financial materiality of these criteria will drive demand for further research. Specifically, increasing numbers of institutional investors, fund managers and financial institutions will need to explicitly request and reward research on environmental, social and corporate governance criteria.

5 In response to the AMWG Materiality research report, brokerage houses in the United States and Canada will likely be interested in the findings of their European counterparts, and as a result may pursue exploring this type of research in their future sector reports.

No North American brokerage houses responded positively to our invitation.Those that responded to the AMWG declined on the basis of a perceived difficulty in analysis due to barriers associated with inadequate disclosure of these criteria (see Finding number two), internal restructuring, or a lack of research capacity.

Policy-makers and investors may be the most effective catalysts for North American research firms to incorporate social, environmental and corporate governance indicators into their work.

Contributing Brokerage Houses and Respective Report Titles

1. **ABN AMRO Equities United Kingdom**
   Pharmaceuticals
2. **Deutsche Bank Global Equity Research**
   Beyond the Numbers: Corporate Governance: Implication for Investors
3. **Deutsche Securities South African Equity Research**
   No Evidence to Link Share Ratings with Good Corporate Citizenship...Yet
4. **Dresdner Kleinwort Wasserstein Europe / Equity**
   Utilities: Emission trading - Carbon Derby Part II: And they're off
5. **Dresdner Kleinwort Wasserstein UK / Europe / Equity**
   Transport: Aviation emissions: Another cost to bear
6. **Goldman Sachs Global Energy Research**
   Introducing the Goldman Sachs Energy Environmental and Social Index
7. **HSBC**
   European Utilities II
8. **NikkoCitigroup Japan Equity Strategy**
   The Global Environment and Socially Responsible Investment: Environmental Technologies Fuelling Zones of Growth
9. **Nomura Japanese Equity Markets**
   Corporate social responsibility (CSR) in the nonlife insurance sector
10. **UBS Global Equity Research**
    European Emissions Trading Scheme - Bonanza or Bust?
11. **West LB Equity Markets Pan-European Equities**
    Insurance and Sustainability: Playing with Fire

AMWG upcoming activities

"A critical next step will be the implementation of the recommendations of this project by investors, analysts, and public sector policy-makers."

Klaus Töpfer
Executive Director,
United Nations
Environment
Programme

1. Engagement with Investors.

- Convey results of the project to institutional investors, mutual funds, fixed income investors, and public and private pension funds worldwide using workshops, Internet and print outreach.

2. Monitor Global Uptake of Results.

- Beginning in July 2005 the AMWG will seek to begin tracking global uptake of the recommendations of the UN Global Compact report on best practice in financial analysis and of the UNEP FI study.

- To facilitate accurate analysis the members have distilled the UN Global Compact financial sector recommendations into a workable ten-point set of criteria.

3. Launch of a Second Round of this Project.

- Date to be determined. Interested asset managers and brokerage houses can contact the AMWG secretariat by emailing materiality@unepfi.net.

Ten Point Indicators for Capital Markets

The UNEP FI AMWG will monitor implementation along the lines of the following indicators.
The AMWG encourages the promotion of the practices embodied in these indicators.

Investors

1 Government and multilateral agency pension funds that integrate consideration of environmental, social and corporate governance criteria into their investment mandates where appropriate.

2 Trustees and their selection consultants who integrate environmental, social and corporate governance issues into their formulation of investment mandates and selection of investment managers.

3 Investors who specify their proxy voting guidelines on environmental, social and corporate governance matters.

Asset Managers

4 Top management and boards that take a leadership role.

5 Brokerage houses that are appropriately equipped to integrate environmental, social and corporate governance issues into fundamental company analysis.

6 Asset Management firms that are actively requesting brokerage house research on environmental, social and corporate governance criteria in fundamental analysis.

7 Asset management firms whose performance and incentive systems reward environmental, social and corporate governance research.

Capital Markets

8 Stock exchanges that include environmental, social and corporate governance criteria in their listing particulars for companies.

9 Accounting bodies and rating agencies that integrate environmental, social and corporate governance criteria into their frameworks.

10 Global Reporting Initiative interaction with local and international investment research bodies.

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