Part 5: Pandemics and Climate Change: Colliding Systemic Risks
Thursday, 16th July at 1600 hours BST

Whilst Covid-19 presents an immediate risk and should be prioritized, shareholders also continue to engage boards on how companies are mitigating the negative effects of systemic threats. In this webinar we explore how to maintain momentum in dealing with climate change, whilst simultaneously dealing with the COVID-19 pandemic.

ICGN is grateful to our Speakers as follows:
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Introduction

The coronavirus and climate change are both systemic risks which need to be managed simultaneously. The pandemic presents the most significant public health and economic crisis of our time and calls for new forms of cooperation on a global scale. In recent years, the challenges presented by climate change have tilted discussions towards environmental risks as well as corporate governance. We know that actions taken now to mitigate the negative effects of both systemic threats will materially reduce the magnitude of the impact experienced by future generations. The UN Sustainable Development Goals provide a plan of action on how to address this.

We all have a role to play; investors scrutinise the ways companies embed the effects of climate change in their business models, while committing themselves to net zero targets in their portfolios, company boards are becoming more competent as the grapple with the effect of our warming planet on business operations in real-time whilst also taking advantage of opportunities arising from climate transition, and governments are toughening up disclosure requirements – ideally aligning with TCFD, but also introducing new policy measures such as carbon taxation and sustainable infrastructure investments.

In this webinar, we focus on two specific questions – 1) what are the hopeful and worst case scenarios for how these two crises could interact and 2) our roles in this; the of investors and public policy – what can investors do to assist the right kind policy framework?

Differentiating between systematic risk and systemic risk

These terms are often confused or conflated. Systemic risks are risks to the system, e.g. COVID-19 is a risk to the healthcare system. Systematic risks are risks which stem from the same cause and are not diversifiable in terms of portfolios. Systematic risks in a portfolio are engendered by systemic risks in the real world. We know that 75-95% of variation in returns are due to systematic factors and are things that security picking and portfolio diversification just can’t affect.

Two main drivers of why this has become such a hot topic – 1) Investors are humans and make decisions based on the conditions of life, not just textbook factors. 2) The
Institutionalisation of asset management and growth of indexation has made people cognizant of universal owner theory. What that means is externalities from one firm (e.g. greenhouse emissions from Firm X) or systematic risks (like supply chain or pandemic preparedness), are going to impact your investments and you cannot stock pick your way out of them. As a result, your returns have a lot more to do with the systemic health of the environmental, social and economic systems than anything you can do without directly trying to influence them. It is not just climate change and COVID-19, but other many other factors too e.g. bias in AI, income inequality, racial justice, anti-microbial resistance, gender diversity, etc. It is ESG, but it is being applied systematically across markets or industries, rather than by company by company.

What is currently top of the systemic and systematic risk agenda?

Beyond COVID-19 and the climate crisis, though it can be seen within climate, is biodiversity. We have neglected the value of biodiversity because it hasn’t been material from an ESG perspective. ESG has evolved to the point of financial materiality, however when you discuss systemic and systematic factors there are many things that do not get priced in.

When LGIM began to engage in climate change around four years ago in a more structured way, we wanted to engage in topics like food and forest, but that’s not at all material to the company’s bottom line, so we had to do quite a lot of internal company work to see that it may not have an impact at the moment on overall return for our clients unless they are considered market-wide or over the long-term by certain sectors or certain companies; so we have to take a stance, even if it is not financially material right now to individual companies. That thought process was important for LGIM to decide these issues (biodiversity, income inequality, fair company payment of tax, human rights – the list goes on) were within our remit to engage.

None of these issues are investors specific problems or individua peoples’ problems, they are everyone’s problem. So it’s important when looking at these themes, to empower governments to do the right thing, whether it be health, climate or income inequality and so on. All of it is coming together in this pandemic period; investors can consider what they are doing to engage with corporates on empowering the government to do the right thing. This relates to the power of lobbying because governments don’t exist in silos and they are being influenced by industries, investors and individuals on what they should be doing, so it matters what our investees are saying about the health system that we need or about the recovery being green.

How are boards dealing with this nexus of issues?

With the caveat that there are always some exceptions, by and large, boards do not think about what they should do regarding systemic risk. They think about what they should do in light of what is happening with the company now and what should be done in relation to their intelligence on what is going to be happening in the medium-term (and really good ones also think about the long-term).

Boards do see the connections or at least how they are affected; for example, poor pandemic preparedness and inadequate healthcare are devastating to the economy and businesses picks up the tab. Or the rise of populism and xenophobia has translated into anti-immigration regimes that are devastating to business in their ability to attract talent or bring talent into the country legally. There are any number of issues where companies recognise
the impacts, but don’t necessarily make the connection back to the systemic cause even if they do, it more often while reading the news on a Sunday afternoon, but not thinking from the role of a board, what should we be doing in my business to influence the context in which we operate so that this issue can be mitigated and we are not left with such a heavy tab to pay?

Plenty of multinationals operating in some of the poorest parts of the world and are well acquainted with the challenges of operating with completely dysfunctional public health, extreme levels of corruption, civil war conflict, etc., and they manage through it using micro-tools e.g. build a hospital for the local community, better security protection, creating a water treatment plant. They do not think in terms of what is my role here to influence the context in which I operate. That largely stems from the feeling that “If I’m the only company that does this, it’s a lot of cost for me and a lot of benefit diluted over everybody else”. Resulting in no strong incentive for businesses take ownership of systemic risk mitigation. There needs to be a push coming from the outside; investors need to raise their voices to be heard in boardrooms to create an awareness that companies have a voice in shifting the dynamics / narrative on dealing with systemic risks.

**Worst-case scenario planning**

Starting with an optimistic scenario, Eni operates in an industry that is faced with unpresented collapse with demand for its core product and based in Italy, the country that was the epicenter of the global infection. What that triggered was a realization of the fragility of the system in which we operate. Eni announced a radial pivot on transition strategy on the day of Italy’s lockdown. Admitting their oil demand is going to peak in 2025, production of natural gas will peak in 2030 and announced a strategy to decarbonize the business, in terms of products, not just operational aspects. Due to collapsing demand and the world having changed irreversibly, they are accelerating their transition pathway. It shows that they can take a disaster, learn the right lesson and then should work with others in the industry so it becomes a movement rather than a couple of companies.

When Mark Carney was asked, ‘what is the purpose of scenario planning’, he said the ‘purpose is to model for failure’. This is a very different thing from stress testing models when companies develop scenarios, which identifies a base case, then plus or minus ten or twenty percent. What they are not doing is assuming a horrific black swan and developing a back-up plan to keep afloat in an extremely negative circumstance and planning for the exit pathways. Although it could mean operating in a sub-optimal or costlier way, but it builds resilience in this current climate of unprecedented vulnerability. The worst-case is that we fail to model for the very worst-case. The realistic worst-case is a complete breakdown of the multilateral world and this is not going to be solved by everyone retreating to inside their boarders. It will cut across every systemic risk that we are exposed to. We all need to ask ourselves what role we can play to come up with solutions that are workable to pull back from the brink.

**Moving from the worst-case scenario to a more hopeful place**

When the pandemic hit it was questioned whether climate change will be ignored to focus on the social disruption, but at LGIM there is still a strong drive for the climate agenda because its not going away. COVID-19 has given a glimpse of the world where we do not operate in the same way, by not flying or seeing each other for everything and this gives some learnings to be had. It has illustrated how we can evolve and what it means to be net zero and the government policies needed to make sure we transition towards this future. The
biggest worry that we are going to run out of money with the economy going down because trillions need to be put into this transition.

What investors can do to increase successful scenarios

This pandemic facilitates a swing back to respect for science and fact in our civil society institutions. COVID-19 proves how dangerous it is to bend nature for our own political and ideological narrative. For investors, the pandemic proves that the economic, social and environmental systems on which our capital markets rely are interrelated and complex. Company philosophy has been based on valuing efficiency over reliance, instead there should be better balance of efficiency, reliance, and agility in the future to respond to systemic and systematic risks.

Secondly, the pandemic has highlighted income inequality and racial justice issues regarding an interplay between economy and the health system. Not only are ethnic minorities and low income communities more likely to die from coronavirus but furthermore in the US black small business owners are more discriminated in a federal way, even if white business owners had poorer financials going into the bank.

Facts and science matter and now we have a renaissance of truth rather than a new dark age of autocratic cruelty. Investors need to accelerate the transition towards dealing with complex systemic issues. We need to develop metrics and tools to measure how well investors do in creating total returns that offset real world-wide issues rather than relative returns and we need metrics that that help the system with health impacts. If we can get those metrics, then we need to figure out a compensation system for asset managers that incentivizes them to focus on total return rather than relative return and the health of the systems. COVID-19 has meant facts and science matter again. Investors have recognized this over the last 3 years, but we have to develop this a step further to develop the metrics and the compensation systems that encourage that.

Public policy is key

We need to focus on the bottom up issues in trying to make companies more resilient by looking at ESG, but also we need to step back and think what are the long term thematic issues that would really drive returns, markets and people. Some investors have been thinking about fundamental changes that need to happen globally to have implications regarding climate change in terms of energy transition, income inequality, digitalization, but all investors need to come together to think about what solutions can we provide and what problems do we have.

Investors can’t change everything as there are certain things they can’t control directly but we can influence indirectly by lobbying. We need to make those we invest in, i.e. media, energy, pharmacy accountable for their actions and output. The likes of influence maps, tools and data sharing are can rank companies based on how they are pushing for certain policies directly or through trade associations, so that is one way we can hold companies accountable. But it is extremely important to do two things, first own firms need to have the right advocacy policies in place so are we saying the right things as institutions. Secondly, we need to consider if we are actually shifting capital? Because we can talk forever but if you continue to invest in the same way it doesn’t really move the dial. Talking about total return vs. relative, we need to think about the right kind of indexes and benchmarks that holds us accountable on sustainable grounds. That is something that we need to build. There needs
to be stick as well as carrot, because we have to actually do something with our engagement and capital allocation and not just talk about it.

Groups driving change

However, a risk on putting the emphasis on public policy is that companies leave it up to government, saying they will comply when government comes up with the right policy. Bob Dudley, former head of BP, said ‘government is the architect, but we are the engineers. If government sets the rules, we will build it’ but that means we remain in a state of paralysis forever. Policy lobbying is the fundamentals of good governance of public policy engagement, which only get you to a certain point in terms of reacting to the world you are in but it doesn’t put you in the forefront of changing the world you are in. An initiative group involving the World Economic Forum (WEF) has been set up, convening non-executive director hubs across G20 countries, with the mission of mobilizing directors to understand the implications of climate change and why it’s essential to act and to acquire the skills so that they know what to do in the boardroom, because awareness is only part of the solution and it’s really hard to translate awareness into action inside the boardroom. It also gives access to fellow directors to share experience and best practice and access to outside stakeholders and experts.

There are eight principles of best practice have been developed through the WEF and number eight is exchange. Boards shouldn’t be closed bubbles that only engage with management, they need to be outward facing, engaging with other parties and outside views, listening to policy makers but also making suggestions to policy makers. We should ask, what is the role of business in shaping policy? ‘CEO activists’ – is a relatively new term, when a CEO takes on the role of shaping the environment in which they operate. Boards also have role to play in demanding this from their CEO and asserting that this is the role of the business leader (for large companies at least, smaller companies can group together and use their voice via organisations such as the CBI). The business voice needs to be activated in favor of changing the signals in the economy, the fiscal, the regulatory, so that companies are rewarded for combatting climate change and not penalized. Companies should be penalized if they harm the climate and not given a free pass and this is where we need to change the current status quo. We need to change the rules and mobilise companies that benefit from the doing good and not harm. We need to pull together the enlightened business leaders, investor community and others that come to COP26 and come with a clear mandate outlining the change and helping enable legislation where this is possible.

How can companies and investors influence public policy?

We can do this by joining together, for example the US Department of Labor is proposing an anti-ESG rule, consistent with the current administration promotion of fossil fuels and Jon has coordinated 30 business leaders for a comment letter to oppose this rule. ICGN did this too with CalPERS. If we all club together we can defeat this rule.

We can encourage appropriate public policy which enables us to do our jobs, we need information to understand system health and the contributions of companies to systemic issues – so we need universal disclosure of ESG factors and need to know these disclosures can be trusted, so we need them to be assured. We need to be actively involved in government initiatives and push for them. We should tend to our own house, asset owners need to ensure their mandates to asset managers, reflect the reality that system health is important – we need to look at time frames and internal compensation and go beyond being
a PRI signatory, we really need to look at how asset managers are actually doing things not just accept what they say.

Data activism – (different from alpha activism) – sometimes investors and investor groups can set standards when governments can’t or won’t, they can be industry-wide or market-wide, it may not be as powerful as government doing so but it is powerful to a degree. For example, there are various initiatives and coalitions on issues such as gender diversity and climate change, bias in AI, human capital, modern slavery, how are people elected to boards. These initiatives can lead to governments taking action later. This is investors saying if government won’t set standards then we will, if you want our money then we want to know that you aren’t going to damage the systems that we rely on for money to grow. Yes we need government, but having an involved and informed investor community that understand the interplay of system health with healthy capital market returns is a condition necessary to get government to legislate. Join coalitions and think seriously about what you are doing to encourage system health.

What can asset owners do to support this process and execute this in their RFPs?
Investors ask about engagement and monitoring but often there is little thought about the systemic risks they are sitting on, how much have they thought about it and what are they doing about it. Often asset owners shy away from things that are ethical and just focus on financial, but they must talk about things even when asset managers don’t have a perfect answer. Investment consultants could assist in this as gatekeepers.

There is another question about short-termism of financial sector – should investors address this factor with the Financial Transaction Tax (FTT) or is there something that can be done in the short-term that is better?

In the mandate discussion, we need to understand the time frames under which analysts and portfolio managers are being paid. For example a well know asset manager who has a 5 year commitment and the first month a public pension fund asked them why they did what they did but the asset manager had to remind them that they employed them for long term and that they won’t be providing further detail until they meet that long-term time horizon.

Regarding FTT, there number of things that can be done, where Jon recently wrote a piece to a presidential campaign on how to scale capital gains tax so that it encourages long-termism. The issue of FTT is that small taxes are designed for public policy reasons (such as discouraging rapid trading) sometimes overtime become fund raising devices for governments, which would be harmful. There are other things can be done i.e. changing how we recognise capital gains, defining high frequency traders as market making activities which would impose obligations on these traders. But there isn’t a qualified yes or no to the FTT but we should focus on how we think about incentives beyond moral encouragement.

We won’t solve this quickly, FTT or other reforms, the investment management industry has been the way it is for a long time, where companies complain with the short term view of investors, but CEOs often say investors don’t get it, “they don’t understand our business model”, “it’s about long-term”, but it should be about building social capital. Few businesses have short value generation cycles – so all businesses deal with this problem. One example, Eni SPA received a letter from the Norwegian government petroleum fund on the question of tax optimization, the letter laid out what they considered the gold standard, and they wanted to know how Eni SPA aligned with that. This letter highlighter that if they don’t meet those standards, then they’d be contributing to a dysfunctional society – so Eni SPA then went to work to overhaul and embed this in their compliance process. Whilst this is a big and
influence voice, it was only one voice however they articulated this point very intelligent and so Eni responded and they changed things. More and more CEOs are in the market for rational reasons why they should do certain activities. Some are to do with maximizing dividends, and they are sick of this, they want to hear a cogent argument for doing the right thing and that they will be rewarded by investors.