



ICGN

International Corporate Governance Network

ICGN Viewpoint

Investor Framework For Addressing Systemic Risks

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Introduction

Led by investors responsible for assets under management in excess of US\$34 trillion, the International Corporate Governance Network (ICGN) is a leading authority on global standards of corporate governance and investor stewardship. Our membership is based in more than 45 countries and also includes companies, advisors and other stakeholders.

ICGN's mission is to promote high standards of professionalism in governance for investors and companies alike in their mutual pursuit of long-term value creation, contributing to sustainable economies world-wide. While ICGN policy priorities are reviewed each year, the promotion of long-term investment perspectives and sustainable value creation remains a constant focus.

Flowing from ICGN's policy priority to promote long-term investment perspectives, this Viewpoint aims to assist investors and their fiduciaries in their understanding of ethics and systemic risks and how these might affect investment analysis and stewardship practices. From an investor engagement perspective, this understanding can help investors to frame their expectations of directors in investee companies, particularly in relation to establishing sound governance practices and mutually agreeable boundaries around ethics, risk-tolerances and risk-mitigation strategies relating to systemic issues.

Risk

For companies and investors alike, risk-taking is not only an inseparable element of strategy but a crucial driver in achieving objectives, including the optimisation of value over time. Risk is a part of every decision a company or investor makes. When corporations choose to ignore or undertake excessive risk, it often reflects governance problems that could undermine sustainable value creation, or ultimately the corporation's own survival.

Institutional investors have a fiduciary responsibility to manage their clients' money in the best interests of beneficiaries, and as such are required to act with a duty of care, prudence and good faith as they pursue a reasonable risk-adjusted return for their beneficiaries. Increasingly, there is a debate in many jurisdictions about the extent to which investors who ignore ESG (environmental, social and governance) factors, ethics and systemic risks are considered to be in breach of their fiduciary duty. However, agreeing on what constitutes appropriate behaviour or an appropriate trade-off between risk and return, is far from straightforward. Risk and return can take many forms, and what one may consider to be an acceptable price to pay, may not be tolerable to another.

Recent corporate crises have served to remind investors and corporations of the inextricable link between ethics and risk management – not only is it unethical to ignore risks but, as has been shown time and time again, acting unethically invites significant risk.

The total risk impacting investors is generally considered to be comprised of two types: that

impacting individual assets (Non-Systemic) and that impacting the broader market(s) and economy (Systemic). Where the first risk can be managed through diversification, the second risk, being the result of systemic issues, has traditionally (at least since the development of modern portfolio theory) been regarded as non-diversifiable-- and at best is mitigated through risk identification and thoughtful response. Against this traditional background, building awareness of systemic risks, including those that are social and environmental in nature, has given rise to calls for “beta activism”—where providers of capital use their voice to influence a “better beta” for long-term market and economic stability and growth.¹

Corporate (Non-Systemic) Risk

Risk management, which has traditionally focused on aspects of financial and operational risk, now also recognises the role played by a broadening range of social, environmental and systemic risks in the pursuit of long-term and sustainable value creation.

The ICGN’s Guidance on Corporate Risk Oversight² aims to help investors assess how effectively a portfolio company’s board oversees risk. It states that:

Strategy and risk are not new concepts, although it is recognised that risk is a subject of increasing attention and regulatory and legislative movements in many jurisdictions. The board’s and investors’ ability to gauge and respond to how a company understands and manages risk has broader relevance beyond the board and investors alone. It bears on the company’s impact on all stakeholders including employees and the communities in which a company does business, and in certain instances, national or international markets.

Financial stability and non-financial factors are both important determinants of corporate strategy. Risk and risk oversight must therefore be understood broadly. Risk is defined as the effect of uncertainties on corporate objectives, recognising that the effect can be either positive or negative. Boards and investors need to consider material risks which are manageable within the organisation’s sphere of influence including but not limited to financial, market, operational, environmental, ethical, fraud, legal and compliance, reputational, environmental and social risks.

This Guidance on Corporate Risk Oversight also reminds boards and investors that, as with other matters of corporate governance, they have a joint responsibility to engage in substantive and effective communication on corporate risk oversight. Active, informed, constructive and periodic communication between board members and investors is crucial for a mutual understanding of corporate strategy, risk and risk oversight. It is therefore recommended that dialogue between the two be founded upon an appropriate and comparable level of respect, trust, seniority, skill and professionalism between investors and investee companies.

Systemic Risk And Its Broader Implications

Not all investment risks are manageable within a company’s direct sphere of influence. Some risks are so broad and ‘systemic’, they are not defined by their cause, but rather by

¹ See Jim Hawley and Jon Lukomnik, The third, systems stage of corporate governance : why institutional investors need to move beyond modern portfolio theory, Research Gate, 2018: https://www.researchgate.net/publication/323323162_The_third_systems_stage_of_corporate_governance_Why_institutional_investors_need_to_move_beyond_modern_portfolio_theory

² ICGN Guidance on Corporate Risk Oversight (2015): http://icgn.flpbks.com/icgn_corp_risk_oversight/#p=1

their potential to negatively impact entire systems, markets or economic segments. The drivers of systemic risk tend to be cumulative and interdependent, resulting in far-reaching impacts, shocks, or even system-wide failures such as the global financial crisis in 2008.

By understanding and addressing systemic risks and opportunities, investors can simultaneously and collectively improve the stability of portfolio investments *and* broader market systems.

The Institute of International Finance defines Systemic Risk as:

...the risk that the financial system or a major part of it—either in an individual country, a region, or globally—is put in real and immediate danger of collapse or serious damage with the likelihood of material damage to the real economy.

The nature of systemic risk is that it builds over time, it is interactive and synergistic and, once in play, is difficult to control³. Some of the more significant systemic threats facing the stability of the global financial system include:

1. Macro-economic risk, including market and credit risk and changes to political, legal, regulatory and fiscal instruments;
2. Environmental risk, including climate change, water scarcity and pollution;
3. Social risk, including human rights, income inequality and populism;
4. Governance risk, including corruption, expropriation of control and corporate culture; and
5. Technological risks, including artificial intelligence and cyber security

Financial markets play a pivotal role in the economy. The consequences of a systemic financial crisis can therefore be far more widespread and harmful than crises in other sectors. Even small events have the potential to create a ripple effect, triggering systemic crises, and ultimately a severe economic downturn. Equally, small but positive actions in financial markets have the potential to significantly compound and reinforce long-term value creation for a broad range of stakeholders. As such, market resilience is a worthy goal that benefits both society and the wider economy.

As all investors will be impacted by non-diversifiable systemic risks, it can be assumed that addressing those risks will improve the overall risk/return profile of investors —particularly for those whose investment horizons are long-term in nature.

As global financial markets develop, there is the danger that the increased complexity and inter-connectedness of financial institutions may itself contribute to systemic risk. The growth of index funds is a case in point – their popularity has resulted in an ever-increasing number of investors owning identical segments of the stock market – for identical reasons. This self-reinforcing behaviour potentially narrows choices and, with fewer opportunities to diversify risk, amplifies the risk of irrational market swings. Systemic risks thrive when circuit breakers lose effectiveness, or in this case, when active managers have less funds available to them to buy undervalued stocks.

Investor Response to Systemic Risks

Either consciously or unconsciously, each investor is likely to possess different values, principles and beliefs in relation to ethics and risk. Given these disparate views, managers and clients stand to benefit from establishing, articulating and adhering to clear position

³ ICGN Guidance on Investor Fiduciary Duties (2018) : http://icgn.flpbks.com/icgn-fiduciary_duties/files/extfile/DownloadURL.pdf

statements. This is particularly important for investors with longer time horizons, such as pension plans.

With systemic risks flowing from a range of economic, environmental, social, or governance factors, frameworks like the UN Sustainable Development Goals and their underlying targets can provide investors with a useful map by which to link capital allocation directly with outcomes that advance progress toward a more sustainable world. Importantly, addressing systemic issues through the lens of the SDGs allows them to be treated as opportunities, as well as risks.

When investors and their clients clearly articulate and share their perspectives it not only contributes to each party's understanding of the degree to which their standards align but serves to clarify the boundaries within which actions and investment decisions can be made. Ideally such position statements will form part of the asset manager's investment policy and work alongside stewardship policies.

Address Systemic Risks: Intentionality

While all risk-management benefits from robust governance processes, successfully navigating the global and interconnected nature of systemic risks requires an even greater degree of conscious and deliberate purpose, or what has been labelled as "intentionality". As risks evolve over time, investment managers who are consistently alert and proactive will be best placed to mitigate the impact of the risks they face.

Where extreme weather-related events such as bushfires and floods were previously considered one-off and diversifiable, they are now attributed to the recurring and systemic nature of climate change. Similarly, globalisation has made risks associated with regulation, terrorism, cyber security and trade wars far more systemic. Ideally, once aware of systemic risks, investors must respond with considered actions around asset allocation, valuation, exclusions, voting and engagement, with both investee companies and underlying beneficiaries.

Building An Effective Framework

In 2016, The Investment Integration Project (TIIP) released a study of Asset Owners' and Managers' Approaches to Investing in Global Systems⁴. The "10 Tools of Intentionality" shown in the diagram below, represents the pathways through which investors can bridge the gap between daily portfolio management decision-making and system-level investing. The report recommends that investors use these tools intentionally, as the portfolio-level discipline of efficiency alone would not naturally lead them to do so.

⁴ Jessica Ziegler, Steve Lydenberg, William Burckart - November 7, 2016 *Tipping Points 2016: Summary of 50 Asset Owners' and Managers' Approaches to Investing in Global Systems*



The 10 Tools of Intentionality: Asset Owners' and Managers' Approaches to Investing in Global Systems⁷

The *Tools of Intentionality* (above) demonstrate how investors can, for both ethical or economic reasons, adopt a range of complementary activities to address systemic issues. While each investor's and each company's framework for responding to ethical and systemic risks may vary, consideration of the following basic framework may help guide the response:

1. Be alert, gather the facts, identify and understand the range of ethical and/or systemic risks that may impact the assets they manage. Remembering these may include corporate externalities with significant environmental, social and economic impacts (as with climate risk or wealth inequality).
2. Confirm the assets classes to which the risks apply.
3. Consider the potential magnitude of ethical and systemic risks relative to pre-determined risk-tolerances.
4. Consider actions that can be taken, including engagement, education, insurance, reduced exposure (value at risk), crisis response, and contingency plans.
5. Weigh up pros and cons of the proposed measures.
6. Identify and analyse preferred action and objectively test validity.
7. Confirm adherence to policies, principles and guidelines (both Governance and Investment)

8. Question whether the action is likely to generate sustainable value. Is it fair, reasonable and likely to result in the greatest good?
9. Act upon the decision.
10. Communicate action, as/if required.

Stewardship and Engagement

For investors, there is also an obligation to exercise responsible stewardship. Such investors can use their voice to encourage both policy makers and investee companies to address the commonly shared long-term ethical and systemic risks that impact companies, investors, individuals, markets and societies.

Through engaging with company management and boards, investors gain insights as to how effectively investee companies are addressing relevant ethical issues and systemic risks.

Basic questions investors could pose to investee companies may include:

1. What are the major ethical and systemic risks currently faced by the company?
2. How do these differ from even a few years ago?
3. How serious could these risks be? How likely is this?
4. Who has responsibility for managing ethical and systemic risks? What is the process?
5. Where in the company's management and governance structure does responsibility for the company's own social and environmental footprint lie?
6. How are ethics, systemic issues and social impact incorporated into Strategic Plans?
7. How does the company manage activities that may potentially have a negative social impact?
8. Can you provide a recent example of how the company mitigated a systemic risk?
9. Does the company have a Statement of Purpose or Corporate Values that relates to ethics and systemic risks? Who owns those documents?
10. Are systemic risks factored into the company's incentive and reward systems?
11. What unintended consequences or "externalities" have flowed from the company's activities?
12. Has the board discussed the relevance of the UN SDGs relative to the company's risk management and/or risk management? What has been the most surprising revelation?

About ICGN Viewpoints

This Viewpoint on addressing an investor framework for systemic risks forms part of the ICGN's broader collection of policy, guidance and model frameworks, which together aim to assist both investors and corporations utilise good governance to promote long-term and sustainable value. It complements a range of related efforts, including those associated with the UN's Sustainable Development Goals (SDGs)⁵, the European Union's Action Plan on Sustainable Finance⁶ and The Investment Integration Project (TIIP)⁷.

⁵ UN Sustainable Development Goals <https://sustainabledevelopment.un.org/?menu=1300>

⁶ European Union's action plan on Sustainable Finance https://ec.europa.eu/info/publications/180308-action-plan-sustainable-growth_en

⁷ The Investment Integration Project <https://www.tiiproject.com>

ICGN Viewpoints are produced by Secretariat and by our member-led Policy Committees. While not defining a formal ICGN position on the subject, they provide opinion on emerging corporate governance issues and are intended to inform and generate debate.

We welcome dialogue with the ICGN Secretariat and/or Committee members as follows:

1. Karin Halliday, ICGN Ethics and Systemic Risk Committee:
Karin.Halliday@ampcapital.com
2. Deborah Gilshan, Chair, ICGN Ethics and Systemic Risk Committee:
deborah.gilshan@the100percentclub.co.uk
3. George Dallas, ICGN Policy Director: george.dallas@icgn.org

This ICGN Viewpoint was drafted by Karin Halliday, a member of ICGN's Ethics and Systemic Risk Committee and the Committee then contributed to the review of this document.