Remarks from Kerrie Waring, CEO, ICGN to the METI Study Group on Improvement of Sustainable Corporate Value and Human Capital

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ICGN's approach to human capital management

ICGN welcomes the work of the Study Group, under the chairmanship of Professor Itoh, convened by the Ministry for Economic Trade and Industry to examine how to link human capital management (otherwise known as HCM) to strategy and sustainable corporate value.

Led by investors responsible for assets of $54 trillion, ICGN is a leading authority on global standards of corporate governance and investor stewardship. Our Members are primarily institutional investors, based in over 40 countries including Japan.

My remarks today draw on ICGN's Viewpoint Report on HCM[1] and our Global Governance Principles[2] ("Principles"). Many ICGN Members default to the Principles as a bellwether for their voting policies and company engagements. The Principles also inform regulators on international standards to help inspire the development of national codes.

This year, the Principles have been reviewed as part of a three-year cycle. We have consciously enhanced our reference to the importance of HCM, and stakeholder engagement more broadly. This requires a commitment to shareholder return on capital while having regard to the interests of stakeholders, including the workforce, customers, suppliers, and communities.

This is particularly relevant now, as stark social inequalities have been exposed by the COVID pandemic. ICGN's Statement of Shared Responsibilities[3] published last year emphasised this and the importance of HCM as a key determinant to a company's long-term value creation.

ICGN's approach aligns with the United Nations Sustainable Development Goals (SDG)[4] to *'achieve a better and more sustainable future for all'*- and particularly SDG 3 on 'good health', and SDG 8 on 'decent work and economic growth.[5]

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[1] ICGN Viewpoint Human Capital Management: Why investors should care and what they should look for in corporate disclosure, October 2018

[2] ICGN Global Governance Principles

[3] ICGN letter to Corporate Leaders, 23 April 2020 (English language): https://www.icgn.org/sites/default/files/6.%20ICGN%20Letter%20to%20Corporate%20Leaders_23%20April%202020_0.pdf
(Japanese language): https://www.icgn.org/sites/default/files/6a.ICGN%20Letter%20to%20Corporate%20Leaders_23%20April%202020_Japanese%20version.pdf

[4] https://www.ilo.org/global/topics/dw4sd/themes/osh/WCMS_558571/lang--en/index.htm

[5] Decent work is employment that "respects the fundamental rights of the human person as well as the rights of workers in terms of conditions of work safety and remuneration. ... respect for the physical and mental integrity of the worker in the exercise of his/her employment."

Regulatory and voluntary initiatives driving sustainable investment

These global ambitions are becoming national realities - the governance of sustainability is no longer a 'nice to have'. It is a must have. Just last week the European Parliament[6] announced plans for a new binding law that ensures companies are held accountable and liable when they harm - or contribute to harming - human rights, the environment and good governance. The European Commission has announced it will present its legislative proposal on the matter later this year.

And on the investor side, ICGN's Global Stewardship Principles[7] outline responsibilities to take account of sustainability related factors, including HCM, in their investment analysis, company engagements and voting decisions. This approach is reflected in dozens of markets around the world, including Japan.

Investors are also subject to regulation, again in Europe, the Shareholder Rights Directive requires asset owners to publish how their investment strategy aligns with the profile and duration of their liabilities and how they oversee asset managers in discharging this. A stewardship obligation to promote sustainable corporate value is hard wired into this.

These regulatory and voluntary initiatives are driving sustainable investment mainstream - the deployment of assets by investors into sustainable index funds reached a record of near $1.7 trillion in 2020, up from 50% over the previous year according to Morningstar[8]. This drives capital to those companies most willing and able to embrace the intangible drivers of value – human and natural capital - as well as tangible financial factors.

The COVID pandemic has boosted this drive and elevated the importance of ordinary workers as pivotal to a company's long-term success, particularly as our economies have shifted away from manufacturing to knowledge-based industries. Companies must demonstrate resilient business models more than ever before. While some market sectors have been badly hit by the pandemic, others have flourished, particularly those with higher standards of governance and HCM practices.[9]

Ultimately, boards and shareholders have a mutual responsibility to preserve and enhance long-term corporate value, contributing to economic growth, social prosperity, security, and a healthy environment. This includes recognition of the materiality of HCM to long-term corporate performance, innovation, risk and sustainable value creation.

Converging investor opinion on optimal disclosure

It is evident that companies with higher standards of HCM are better equipped to sustainably improve corporate value.[10] But investors lack consistent and reliable data to assess HCM performance which is crucial for decision making around investments, voting or company engagement.

Mandatory disclosure is limited in most markets. So, investors must rely on voluntary reporting that is often boilerplate, supplemented by data from research firms. While this is helpful, it does not enable deep analysis of specific companies or comparisons to be made

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[6] MEPs: Companies must no longer cause harm to people and planet with impunity | News | European Parliament (europa.eu)

[7] ICGN Global Stewardship Principles

[8] Morningstar – Global Sustainable Fund Flows: Q4 2020 in Review.

[9] The Playing Field, A Look at the World's Largest 50 Asset Manager, SquareWell Partners, February 2021

[10] The review can be found in: Bernstein, Aaron and Larry Beeferman, The Materiality of Human Capital to Corporate Financial Performance, Pensions and Capital Stewardship Project, Labor and Worklife Program, Harvard Law School, 2015, available at: https://lwp.law.harvard.edu/files/lwp/files/final_human_capital_materiality_april_23_2015.pdf

amongst competitors. A multiplicity of reporting frameworks is also inefficient for companies, causing complaints about survey overload.

However, there is growing consensus around how companies should measure HCM and what should be disclosed. Many ICGN Members are calling on regulators to require companies to publish better information around how human capital is managed as part of a longer-term strategy for value creation.

By way of example, last year, ICGN issued a letter[11] to support the Human Capital Management Coalition (a group of investors responsible for $6 trillion assets) which called on the United States Securities and Exchange Commission (U.S. SEC) to require companies to disclose information about their human capital policies, practices and performance.

The SEC Chairman, Jay Clayton, emphasized the importance of human capital in a statement discussing the need to maintain connections amongst markets, business and workers in managing the COVID crisis. He said, *"I believe that the strength of our economy and many of our public companies is due in significant and increasing part to human capital and, for some of these companies, human capital is a mission critical issue."*

ICGN subsequently welcomed, a change of reporting rules by the SEC to require companies to report 'material' human capital objectives. This is a useful 'first step' but we encourage the SEC and other regulators to require more comprehensive disclosure – including information around the indirect workforce (contract, part-time and temporary).

Since the new SEC rule was implemented in the U.S, there has been a surge of HCM reporting however a recent study[12] finds that disclosure is limited: a third of companies sampled described their approach to HCM in just 300 words or less (and typically on a single topic), while another 48% published 1,200 words or less. This is inadequate to be genuinely useful to investors.

Disclosure should be tailored to the company's specific HCM strategy and include information on like:

- Investment in training
- Lost-time injury and fatality rates
- Pay ratios (across highest, media and lowest quartiles)
- Turnover (voluntary and involuntary, internal hire rate)
- Compensation and incentive plans
- Workforce demographics (full time, part time, agency)
- Workforce engagement, union representation, work-life initiatives
- Gender, ethnic and racial diversity across different workforce levels particularly in relation to recruitment, retention and promotion

This data may seem overwhelming, but companies already generate this for internal purposes. So publicly disclosing the data is not likely to require burdensome new data collection systems and reporting frameworks. And importantly, a consistent approach to definitions will enable investors to compare companies on HCM, as they do in more traditional financial metrics. Disclosure should also be supplemented with key performance indicators (KPIs) covering relevant policies and their outcomes. This should include measurable goals and a period over which KPIs are achieved.

[11] ICGN Letter to U.S. SEC re Modernization of Regulation S-K Items 101, 103 and 105, 26 August 2020
[12] Human Capital Management Proxy Disclosures; sample of December 2020 & January 2021 proxy filings, Semler Brossy, PowerPoint Presentation (semlerbrossy.com)

Board responsibilities and shareholder engagement

According to a recent report from Deloitte and the Society for Corporate Governance[13], HCM was ranked in the top three emerging issues that boards will prioritise in 2021, following diversity and pandemic recovery. The report also found that, typically, Human Resource Directors serve as the liaison to the board on matters such as corporate purpose, culture, diversity, equity, inclusion and HCM.

Good HCM practices around health and safety, training and incentives are crucial for worker satisfaction, leading to higher productivity and superior services for customers. This helps companies innovate and remain competitive in a global economy and is a key driver of long-term value creation.

HCM can also impact a company's reputation and, in extremis, create legal liabilities. A poor corporate culture with misaligned HCM has featured prominently in corporate failures in recent years. It is therefore imperative that boards and management recognise the workforce as a source of value – not as a cost – and instil investor confidence based on a strategy for talent management, succession and diversity policy aligned with a company's purpose.

To ensure that boards are properly equipped to oversee HCM, companies should:

- Appoint independent directors knowledgeable about HCM
- Enhance director understanding through education
- Align CEO incentives with HCM related KPIs

Boards should report on how their HCM approach relates to the company's purpose, business model and strategy. This extends to the impact of the workforce on value in relation to costs, productivity, quality and revenue. Boards should be prepared to engage with shareholders and stakeholders on a variety of HCM issues and I will conclude by offering five questions for reflection:

1. How are workforce-related risks and opportunities managed? For example, in relation to health, safety, well-being and human rights.

2. How does recruitment align with the company's diversity policy, talent management and succession planning?

3. How has workforce retention, training, promotion, and engagement contributed to corporate performance? Linked to this is the importance of communicating expectations around culture and behaviour.

4. How diversity, equity and inclusion is managed at the board and workforce level. This extends to ensuring no discrimination and fair representation in different committees and leadership roles.

5. Fair pay, working hours and how incentives are distributed – particularly the level of CEO pay compared to ordinary workers.

I will conclude by saying that, as we overcome the challenges presented by the COVID crisis, we must also rebuild trust in capitalism. This requires a deep understanding of what drives and protects long-term value, beyond just financial returns and think more holistically about governance, the environmental and social impacts with a particular focus on human capital management.
Thank you.

[13] Board Practices Quarterly: 2021 Boardroom Agenda, Deloitte and the Society for Corporate Governance - February