RBC Global Asset Management

Who's responsible for irresponsible business

ESG Exchange VI
19th November 2019

The RBC ESG Exchange is a series of discussions that bring together thought leaders and industry experts who are passionate about environmental, social & governance (ESG) related topics, to share their views and opinions. The opinions expressed herein are those of the individual and do not necessarily represent those of RBC Global Asset Management (UK) Limited.

The ESG Exchange VI

The Exchange took place on 19 November at the Institute of Contemporary Arts in London. The session began with a talk from our keynote speaker **Professor Colin Mayer**, Peter Moores Professor of Management Studies at the University of Oxford's Saïd Business School, who spoke about the role of the corporation in today's society. **Claire Spedding**, Director at the National Grid, then discussed the topic of decarbonisation with **Ben Yeoh**, Senior Portfolio Manager and ESG Specialist, RBC Global Equity team.

Colin began his session by explaining that he was going to talk about one of the most important institutions in our lives – one that clothes, feeds, and houses us, employs us and invests our savings. Business is the source of economic prosperity and the growth of nations around the world, but has also been the cause of inequality, environmental degradation, and mistrust.

Every year for the past 36 years, Ipsos Mori has conducted a survey of 1000 people in Britain asking which professions they trusted. Nurses, doctors, and teachers top the poll, with estate agents, professional footballers, journalists, and politicians at the bottom. Business leaders also ranked poorly, below bankers, trade union officials, and the man or woman on the street. The survey results indicate that mistrust in business is profound, pervasive, and persistent. Why is this the case?

Colin suggested that this goes back to the 1970s and the so-called Friedman doctrine, named after the Nobel Prize-winning economist Milton Friedman, who asserted that the only social responsibility of business is to increase profits – as long as this is done within the rules of the game. According to Colin, this has been the foundation for business practice, policy, and education ever since.

But it wasn't always the case. 2000 years ago, the corporation was established under Roman law to collect taxes, mint coins, and maintain public buildings. It combined its commercial activities with the public good. It's only in the last 60 years that business's sole purpose has been seen to be making money, and Colin believes this is likely to get worse before it gets better. Why?

While technology offers many opportunities to enhance our wellbeing, it also poses risks. On this theme, Colin focused on artificial intelligence (AI) and how it could threaten the world of work. He stated that the main impact of AI will not just be on manual labour, but also on intellectual labour: as machine learning accelerates, machines will be able to take decisions for us. This is not science fiction, it is actually happening. It has been suggested that AI could potentially replace judges in court rooms and directors in boardrooms. This raises profound questions about who is programming the algorithms and for what purpose.

For this reason, in January 2018, the British Academy launched a major programme of research into the future of the corporation. The premise of its first report, published in November 2018, was that our view of business needs to be reconceptualised. To do that it brought together academics, business leaders, and policy makers from around the world. What emerged, according to Colin, was an important concept that has gained traction.

In January 2019, Larry Fink, Chairman and CEO of BlackRock, said that, "*Every business needs a purpose and . . . that purpose is not the sole pursuit of profits, but the animating force for achieving them.*"

In August 2019, Business Roundtable (BRT), a non-profit association based in Washington, D.C., discarded its 1997 statement on shareholder primacy, and issued a statement asserting that businesses should move away from pure profit maximisation in favour of corporate purpose which focuses on delivering value to customers, investing in employees, supporting communities, sustaining the environment, and creating long-term value for shareholders. In September 2019, the Financial Times launched a campaign that called for a "reset of capitalism" to focus businesses on delivering profits with purpose.

These all relate to the questions of: why business is created? Why does it exist? What is it there to do and what does it aspire to become? In other words, its purpose.

Colin surmised that the purpose of a business is not just to deliver profits. It should provide profitable solutions to the problems of people and the planet, and profits are a by-product but not, per se, the purpose of a business. Businesses do not profit by creating problems for people or the planet; instead they commit to a corporate purpose.

To achieve this, reciprocal relationships of trust with mutual benefits for all parties, including the firm, its employees, suppliers, shareholders, and society are necessary. Businesses must have values of honesty and integrity and commitment to the corporate purpose.

Colin clarified that the term corporate purpose is neither descriptive nor aspirational – it is precise; it is about the problems companies are addressing. How are they doing this and over what period? And for whom? And how is that company particularly suited to solving that problem?

One example of strong corporate purpose is the Danish pharmaceutical Novo Nordisk, which is one of the world's largest producers of insulin medicines for people with Type 2 Diabetes. Several years ago the company realised it was failing to deliver insulin to those parts of the world that most needed it. 85% of people with Type 2 Diabetes are found in low and middle income countries, many of which could not afford to purchase Novo Nordisk's product. The company concluded that its purpose was not merely to produce insulin medicine, but was to help people with Type 2 Diabetes treat it. This might involve taking insulin but in many cases it would not.

The company worked to identify which treatments worked best in different parts of the world, but eventually realised that its purpose was really to help people avoid getting the disease in the first place; basically to eradicate Type 2 Diabetes. Novo Nordisk worked with local healthcare professionals and national governments to identify changes in lifestyle that would help people avoid getting Type 2 Diabetes.

While very noble, didn't this undermine the company's business model? Colin described how these efforts had quite the opposite effect and the business has flourished. Novo Nordisk created relationships of trust and became a trusted supplier of not just insulin but of pharmaceutical products in general and advice on how to address health matters.

How did Novo Nordisk achieve this? A company should be clear about its purpose. This behaviour exemplifies how corporate purpose can be incredibly powerful for promoting the success of a company as well addressing problems around the world. It establishes a degree of trust that would not otherwise exist.

How can more companies succeed in this way? Colin noted that Novo Nordisk's ownership structure is an important feature. The company is traded on the Copenhagen stock market but its largest shareholder is a foundation, the Novo Nordisk Foundation, which owns the largest block of shares. That stability has allowed the company to pursue its corporate purpose.

In 2019, the British Academy programme turned its focus from the reconceptualisation of business to seek to identify the policies and practices that need to be in place to implement that reconceptualisation.

Its second-stage report, *Principles of Purposeful Business: an Agenda for the Future of the Corporation in the 2020s*, was launched on 27 November 2019.

The report describes four pairs of policies around which reform needs to take place: law and regulation; ownership and governance; measurement and performance; and finance and investment.

The report identifies the following current definitions of these policies as they relate to business:

POLICY DEFINITIONS

Law: Fiduciary responsibility of directors to shareholders
Regulation: The "rules of the game" and their enforcement

Ownership: Concentrates on shareholders' rights
Governance: Solving the problem of aligning managerial interest with shareholder interest

Measurement: Accounting for physical and financial capital
Performance: Profits

Finance: Interest of savers
Investment: Investment on their behalf to maximise the value of their shares

The alternative reconceptualisation, below, suggests that a different set of policies is required to "reset" capitalism - ultimately it is the system that needs to change:

- **Law**: Should require companies to define and deliver on their corporate purpose. A good example of this is the Public Benefit Corporation in the U.S., which does exactly that.
- **Regulation**: Should seek to align the corporate purpose, especially for companies that perform public functions, with the public interest.
- **Ownership**: Should concentrate on companies' stewardship role, and the Stewardship Code in particular, which was recently amended. This is becoming increasingly important as the legitimacy of ownership of companies is being questioned.
- **Governance**: Should concentrate on aligning the interests of management with the corporate purpose (rather than just the interests of shareholders), as per the Financial Reporting Council's new corporate governance code.
- **Measurement & Performance**: Should measure a company's impact on parties and assets it doesn't own and ask whether companies meet their corporate purpose. This is increasingly happening already as part of the ESG industry, but it remains problematic as the quality of the

information that underpins the efforts is very mixed and lacks standardisation and consistency. Performance should be measured against the success of companies in meeting their corporate purpose.

- **Finance & Investment**: Should be about the role of the financial system to align the interests of private companies and financial institutions with their social purpose and to build strong relationships.

The report suggests that the adoption of these redefined policy pairings is required to bring about the transformation of the nature of business.

Another example of a company that is embracing its corporate purpose is Swedish bank Handelsbanken. It has been growing steadily over the last 40 years and is now one of the fastest-growing banks in the UK. It needed no bailout during the financial crisis and it has one of the best capital adequacy ratios, one of the best liquidity ratios, and one of the best credit ratings in the world. It also has notably high levels of customer satisfaction and loyalty. Handelsbanken has exactly the inverse structure of traditional banks around the world. The company is decentralised and its mantra, "The branch is the bank," empowers branch managers to make decisions. This has allowed branch managers to build up relationships with customers and Colin stated that the bank's success is predicated on this trust. The bank motivates people, paying a lot of attention to the selection of branch managers and instilling the values of the bank into those managers. Handelsbanken pays no bonuses to staff until they retire at 60, at which time they get a share of the bank's profit-sharing scheme. Handelsbanken is listed on the Swedish stock market with two major shareholders, one of which is Oktogonen, its profit-sharing scheme. Basically, Handelsbanken owns itself and it has the stability to pursue its corporate purpose.

The traditional view of capitalism is that it is an economic system of private ownership concerned with production and profit. An alternative view is that it is a profitable solution (public & private) for people and the planet.

Colin concluded his session by asserting that there is an obligation for business owners to uphold the corporate purpose and that trust is an important and largely unrecognised asset that companies possess. Commercially successful companies are trustworthy companies, and the competitiveness of nations relies on the trustworthiness of its corporations for the prosperity of the many, not of the few, and for the future as well as the present.

A brief Q&A session followed. The first question touched on the ascendancy of the East, and how this would influence western capitalism.

Colin replied that business is different around the world, and even within Europe the nature of company ownership varies markedly. The UK is extreme in terms of the dispersed nature of its ownership. It places more emphasis on the operation of capital markets in terms of the allocation of resources as well as the control of companies than anywhere else in the world. Outside of Europe there is much more in the way of block holdings of companies and families are by far the largest single shareholders of companies in many countries in the world. That is also true of most Asian countries, except China and Japan. In China the dominant form of block ownership is by the state, and in Japan it used to be through bank ownership but now is cross-ownership between companies. Block holdings provide a degree of stability that is absent from the type of ownership pattern that exists in the UK.

There is also a difference in philosophy about what business is supposed to be doing and its role in society. In Japan there is a focus on lifetime employment and on providing a benefit for society at large.

Colin was then asked how we bring about change to transition.

Colin cited a dramatic change in attitude in the last few months, let alone years. These ideas are now better received. There is a fear among businesses that if they do not get on with implementing change, someone else will, namely regulators or politicians. That is pushing companies to change. Popular movements, especially those related to the environment, have helped to usher in a realisation that it is necessary to be able to deliver better performance for companies. The key element is the investment chain. There are plenty of boards of companies who would like to move in this direction but find it difficult to do so. How do we change behaviour within the investment community to encourage the owners of companies to take responsibility for promoting the successful implementation of those companies' purposes? Sovereign funds have put increasing emphasis on having more direct engagement with their investment managers to specify their mandates more clearly. We need to establish the stable block shareholders alongside the more liquid shares that are traded actively.

ESG is increasingly recognised as a risk class and offers investment opportunities, but there are new forms of ownership that are gaining traction, for example the role of key anchor shareholders to act as trustees on behalf of a broader group of parties. The UK does not have many such companies, but it does have manifestations of them, some which are employee trust firms, such as John Lewis. The reason it's important to emphasise the "trust" part of the employee trust firms is the trust will act not only on behalf of the current generation of employees, but also on behalf of future generations.

Ben then introduced **Claire**, who talked about the challenges within the energy sector, and about decarbonisation and innovation at National Grid (the Grid).

Claire began by talking about how she oversaw the trading team that took the decision which led to the UK's first coal-free day in 2016 when she ran commercial operations (the "money side" of operation) for the Grid.

As background, Claire had previously been responsible for the UK's security supply at a time when coal-fired power stations started to disappear from the UK's energy mix. It was not going to be economic to use only fossil-fuelled power stations and as a result, research was carried out to determine how the Grid could run without relying on fossil fuels. One of the main problems to be overcome was something called "black start capability" which is the process of restoring the Grid after a power cut. Many of the coal power stations running at the time were critical in providing black start capabilities.

On a particular day in April 2017, after extensive research into alternative means of providing black start capability, the Grid was able to meet all of its security of supply obligations without the support of any coal power stations and therefore it became a "no coal" day. This information was released on Twitter and became a global event with people like Al Gore and Matt Damon using social media to spread the word that the UK had gone coal free for a day.

This viral event set the ball rolling for a programme of work to increase the number of days the Grid could run without coal. The most recent record is two weeks with no coal generation. The System Operator at Grid has pledged to run only on low carbon (including nuclear) energy by 2025.

After its privatisation in 1989, the Grid had successfully stripped a lot of costs from the business. But in 2013 the regulator determined that focusing just on cost efficiency would not be sufficient to prepare for the future. As a result frameworks were put in place to facilitate increased investment in innovation for future technology to put the UK in the best position possible to operate in a decarbonised world.

Claire posited that the National Grid is a good investment for pension funds as it has stable returns but it also has a huge social obligation because it is an essential service. Most of the people who work at National Grid do so because of that social obligation; people are very aware of the impact they have on everyone's lives.

Diversity of thought is going to be very important to the innovation agenda at the National Grid, and there is a realisation that leaders in the field need to be connected to wider society.

In the future, Claire noted, the Grid is going to rely on a mix of energy, and the more diverse the supply – inter-connectivity, nuclear, wind, solar, tidal - the more resilient the system will be. In the UK there are individual intentions, but no detailed coherent policy to drive them currently. There are huge opportunities for investors in the energy market, but it is complex without a coherent policy. While there is awareness of environmental issues, it exists at a high level and lacks a concrete plan of action to address these issues.

Energy decarbonisation in the wider world will stem from decarbonisation of the electricity grid, through transport and into heat. The electricity grid is well underway, and transport is also in progress; heat, however, is more difficult as there is no universal solution. What works in one part of the country would not necessarily work in another, and possible solutions would affect people's homes, potentially requiring a change of household appliances. In the winter of 2017/18, in the UK there were 17,000 deaths directly attributable to homes that were inadequately heated and so clearly there are multiple benefits to addressing the problem of inefficiently heated homes.

Claire speculated that as we move away from fossil fuels, the cost of energy generation (excluding nuclear) will decline because there is so much investment into innovation. Most renewables still need some kind of subsidy, but they are at a tipping point. There is a real drive to bring down the cost of the components, thereby bringing down the ultimate cost of generation. The other side is the cost of operating the Grid.

There is much debate about the cost of energy to the consumer versus the cost to the planet, but at the moment people appear more concerned about the personal energy costs than climate issues. What is missing is someone to "tell the story" about energy in the same way that Sir David Attenborough focused public attention on the problem of plastic pollution in our oceans.

Ben ended the session by asking Claire to answer "over-rated" or "under-rated" to the following issues:

Fossil-fuel subsidies: *Over-rated*
Carbon tax: *Under-rated*
Innovation: *Under-rated*

Biographies

Colin Mayer CBE

Peter Moores Professor of Management Studies

Colin Mayer is the Peter Moores Professor of Management Studies at the Saïd Business School at the University of Oxford. He is a Professorial Fellow of Wadham College, Oxford and an Honorary Fellow of Oriel College and St Anne's College, Oxford. He is a member of the UK Competition Appeal Tribunal, the UK Government Natural Capital Committee and the International Advisory Board of the Securities and Exchange Board of India.

Colin Mayer was the first professor at the Saïd Business School in 1994 and the Peter Moores Dean of the Business School between 2006 and 2011. He was a Harkness Fellow at Harvard University, a Houblon-Norman Fellow at the Bank of England and the first Leo Goldschmidt Visiting Professor of Corporate Governance at the Solvay Business School, ULB.

Colin Mayer researches in the fields of corporate finance, governance, regulation, taxation and the role of the corporation in contemporary society. He works on the nature of the corporation, the regulation of financial markets and institutions, and their effects on the financing and control of corporations. The common theme of his research is the international comparative nature of corporate finance and corporate governance and the relation of these to financial markets.

Claire Spedding

Director, National Grid Smart

Claire is passionate about facilitating the transition to a decarbonised, decentralised energy system through embracing innovative and disruptive technologies; and promoting the growth of diversity and inclusion in the energy sector.

She is Director of National Grid Smart, National Grid's smart metering business, and has had a long and varied career since joining the National Grid Group in 2002. Career highlights include representing National Grid in the London 2012 Olympics control room, leading a high-performing deal team to agree critical national contracts and outperforming financial targets to optimise the c.£1bn cost of operating the GB electricity system.

Claire is named on the @rise_utils list of the top 25 UK influencers in the energy industry, in the top 1000 @SustMeme global influencers on Climate & Energy and she also sits on the Advisory Board for the Oxford University-run UK Centre for Research on Energy Demand.

Ben Yeoh

Senior Portfolio Manager, RBC Global Equity

Ben is a Senior Portfolio Manager and the Global Equity team's Healthcare sector specialist. In addition he is the team's ESG expert and sits in a non-executive advisory capacity for Responsible Investment and ESG for a leading UK investment trust. Prior to joining RBC Global Asset Management in early 2014 Ben worked in the same capacity for three years at First State Investments. Previous experience includes roles at Atlantic Equities where Ben was responsible for global healthcare research with a special focus on the US and at ABN AMRO where he was recognised with a #1 Thomson Extel rating across all sectors for integrated ESG research. In 2012, Ben won the Starmine award for best stock picker in Healthcare.

Ben holds an MA (Natural Science) from Cambridge University gaining the top first in his year. He won a scholarship to Harvard University and studied there at post graduate level specialising in behavioural neuroscience. Ben is a CFA charterholder and a member of the UK's Financial Reporting Council's Investor Advisory Group.

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