Wake-up Call **Sir Anthony Salz**

The 2008 financial crisis pointed to failures in culture and leadership. The financial services sector needed to change. In a fiercely competitive industry, this required action by governments and regulators. Many in the industry were keen to get back to how things had been. Short term pressure on relative financial performance provided more powerful motivation than the calls for cultural change. The complexity and sheer scale of the organisations made change difficult. It was a missed opportunity. But, at least, there were significant improvements in the resilience of the financial system, enabling it to cope better with Covid-19's dramatic impact.

Many business leaders have referred to Covid-19 as a wake-up call. While they will not have the same ideas, the broad sense is that we should take the opportunity to pause and reflect on how we run our lives and businesses, how well we act as stewards for the huge advances in technology and science, how we look after the capital entrusted to us by the public and how we engage with our workforces and contribute to the communities within which we operate. To take this opportunity requires strength of purpose, time and, at least in a business context, leadership. All the more so given the economic stresses resulting from the pandemic and the apparent reassurance of a return to "normal". The opportunity is to work out what will make businesses more resilient and sustainable for the long term and better able to serve society.

So why should it be different this time? There has been a growing sense of the importance of environmental, social and governance (ESG) factors, alongside financial factors, in the investment process. But how do we prevent ESG becoming a cliché, supported by lengthy sections in annual reports that are read by few and mean little to the true strategy and purpose of an organisation. Companies and investors have the opportunity to take the initiative before governments do so.

Covid-19 should make us stop and think about existential risks in our world; risks that humanity has created. Do we take too much for granted? Do we avoid taking responsibility for big global risks, leaving it to governments to sort out?

The financial crisis had its warning signs - risk committees should have been aware of the growing risks of bank leverage, the pricing of financial risk and the incentives for individual risk taking. The reputation of the financial sector was badly damaged. Not enough had been done by boards to focus on behavioural risk and the culture within their organisations. In the case of Covid-19 there were also warnings. SARS and Ebola set off alarm bells. And Bill Gates, for example, warned of the need to take steps to mitigate the risks of a pandemic. Covid-19 was seen by many as "low-likelihood" in the sense that there was no recent occurrence of a dangerous virus spreading so quickly across the whole world. With limited experience, it can be hard to imagine the impact. How many boards or risk committees or investors spent time imagining the potential impact? What ability did they have to mitigate the risk, especially SMEs?

The costs of not heeding warning signs can be huge. The financial crisis resulted in over $US2trillion of bank writedowns and over $US10trillion in lost economic growth. With the pandemic - restrictions on people moving around, getting to work and engaging in economic activity - estimates of loss to economic growth continue to escalate and lately have put at about $US18trillion. The pandemic has threatened businesses, even entire industries. Without massive government intervention to provide liquidity and to support staff costs, many businesses would have already failed. And many will when support is withdrawn. We can be sure that there will be major threats to humanity's existence in the future. How do we reduce the likelihood of such threats and/or reduce their impact?

Boards are facing the immediate implications of the Covid-19 crisis, including the health of their people and the short term viability of their business. This may allow limited time to look to the medium and long term to identify the implications for their business model and the opportunities - to assess what they should learn from the pandemic, to look again at their approach to risk, and how in particular cases they access the necessary expertise to decide on the likelihood and the impact. There will be winners and losers from the crisis. Some just because their business happens to be in the right or wrong sector. Others because they adapt quickly. To provide the time for considering the need to change (the wake-up call), some companies have separated out a team specifically to look at the future.

One evident area of warning is the environment. Do we continue to ignore the weather extremes, such as exceptional forest fires in Australia, extensive flooding in parts of Europe? Do we ignore the relentless use of natural resources, the vast amounts of waste, the pollution of rivers, the degradation of soil, the extinction of species and the plastics in fish? We marvel at aspects of the natural world yet fail to look after it. There is a sense that our exploitation of nature is finally catching up with us, that we are sleepwalking into ever more extreme climatic events and failing to take responsibility. Companies should be approaching these environmental issues as a material risk factor for a sustainable business - not wait until they are pressured into action by regulators or stakeholder groups, or by employees or customers, or until they are overtaken by a major environmental crisis with huge associated costs.

There is insufficient consistent collaboration among countries, not least from some that should be providing effective leadership. National self-interest seems to take precedence. As a result, it is left to a teenager and a loosely organised group, aptly named Extinction Rebellion, to maintain attention and to stress the urgency.

There are many questions for businesses. Are they taking their share of responsibility, living their values and statements about sustainability, accepting the costs in the short term? Do they recognise the crisis? How can they make a difference? Or are they waiting for government and others to take the lead? Might the future costs of a failure to act much outweigh the short term costs? How high is this risk on board and risk committee agendas? What expertise is needed for boards to understand the risks and the potential impact? Should there be more collaboration among companies to improve the effectiveness of the response? Is it the anti-trust laws that discourage effective collaboration? Covid-19 will give rise to all sorts of disputes about whether policies provide insurance cover. Do boards understand where financial risk lies in relation to environmental costs and damage (including litigation)? Boards are expected to focus on some of these questions as a result of the processes and disclosures recommended by the Task Force on Climate related Financial Disclosures (TCFD). This includes a recommendation that companies describe the targets they use to manage climate-related risks and opportunities and performance against targets. Public expectations are changing.

In the area of governance, the UK's governance code describes a successful company as one led by an effective and entrepreneurial board, whose role is to promote the long-term sustainable success of the company, generating value for shareholders and contributing to wider society. It expects companies:

- to be clear about their purpose, values and strategy and to align these with culture,
- to measure performance against objectives,
- to have effective engagement with stakeholders, especially shareholders and employees.

As regards employees, it expects policies and practices to be consistent with the company's values and support its long-term sustainable success, enabling the workforce to raise any matters of concern. This might, for example, include social and environmental impact.

As a general proposition, the latest version of the code gives increased emphasis to sustainability, the long term and engagement with stakeholders. It states that the board "should assess the basis on which the company generates and preserves value over the long term. It should describe in the annual report how opportunities and risks to the future success of the business have been considered and addressed, the sustainability of the company's business model and how its governance contributes to the delivery of its strategy." The direction of travel is towards greater engagement with a broader set of stakeholders and the development of the responsibilities of institutional shareholders.

Specifically, the code provides that when 20 per cent or more of the votes have been cast against a board resolution, the board should explain what actions it intends to take to consult shareholders in order to understand the reasons behind the result. So 20% opposition becomes an important threshold.

There is a sense that asset managers are increasingly interpreting their stewardship responsibilities as extending beyond short term financial performance to an interest in sustainability and resilience. BlackRock and State Street were among the early leaders in this move. One leading UK asset manager recently said "we must think about the social and environmental return. A holistic return for the investor is the way forward…..The [investment industry] must act as good stewards of what we've invested in, we must leave companies better than we find them."

Alongside this emphasis on broader stewardship responsibilities is the emergence of organisations that coordinate shareholder action to put pressure on boards to change their policy. In the UK, for example, ShareAction was behind 24% of Barclays Bank's shareholders voting for a resolution asking the bank to phase out financing for fossil fuels and utility companies that are not aligned with the Paris climate goals. ShareAction describes its role as building the movement for responsible investment. It seeks to point out the importance of the investment system and argue that capital should be more accountable. According to ShareAction, "£50 trillion is invested in companies that we buy from, that employ us, and that shape the world we live in. A lot of this money belongs to ordinary people and we have a stake in the way that it is spent". Its particular vision is of an investment system that truly serves savers and communities.

This is reinforced by changes to the responsibilities of Boards under corporate law to take account of the interests of a wider range of stakeholders than shareholders - [Footnote 1]. Yet there is no clarity as to how to measure the benefits of meeting these wider responsibilities. So long as the only meaningful metric for performance is profit, Boards find it difficult to weigh the long term benefits against the short term expectations. In the area of climate change, the collaborative work of the TCFD is a meaningful step in providing a framework for effective financial disclosures, designed to help the measurement of, and response to, climate change risks.

The argument is that a company which takes a broader perspective will reinforce trust among its stakeholders and the public and so strengthen its brand, leading to greater sustainable, long term value. The focus is on resilience rather than the short term. For example, Covid-19 has shown how the short term financial benefits of highly cost efficient supply chains can adversely impact resilience in a crisis.

With broader accountability, it will be important for Boards to understand changing public expectations in an unpredictable world. A world where there is considerable transparency and where expectations are changing, encouraged by younger generations finding a voice, assisted by social media and given relevance by a more engaged investment community. A recent example is the public pressure on HSBC and Standard Chartered to criticise China's treatment of Hong Kong. These are difficult reputational decisions for Boards, with financial risks either way. It is for those Boards to reconcile their decisions with their stated values and their stakeholder expectations. HSBC's values include "standing firm for what is right". This will mean different things to different people. But there is an increased likelihood in such

high profile situations that Boards will be required to justify their decisions publicly, and to investors.

The UN's sustainable development goals offer a framework for public expectations [Footnote 2]. Perhaps every Board should consider how its activities fit with these goals. While their global and aspirational application may seem to make them irrelevant, many of the themes will have some application in the communities in which businesses operate.

Learning from Covid-19, there are all sorts of risks to humanity, including nuclear war and an asteroid collision. Below are three broad risk areas that could impact a company's sustainability. Some risks will appropriately fall to Governments or international organisations, yet it will remain important that companies understand the extent to which the steps they are taking are effective and what exposure is left.

1. **Science and Technology**: Humanity has made significant strides with science (including medicine) and technology. Indeed, the adverse economic impact of Covid-19 were much reduced by internet enabled virtual communications and the collection and sharing of crucial data. Medical research may provide yet an effective treatment or vaccine. In the sciences there is more regulation to test the side effects of new discoveries. With technology there tends to be a rush to take advantage of new products before we have worked out the risks. How resilient are companies to the technological and scientific risks, such as intentional or accidental disruption of the internet or power supplies, the impact of cyber-attacks, or the intentional or accidental spread of pathogens? Do we understand the impact on our health of electro-magnetic fields, the impact on our lives of AI or the impact on our minds of the use of internet communications? This is only the beginning of the technology revolution - are we equipped to make good decisions about its future and its human impact? Are companies facing up to these uncertainties and their potential impacts?

2. **Inequality**: We celebrate the fact that (before Covid-19) there were significant reductions in levels of poverty across the world as a whole. Yet there is indefensible inequality within many developed economies.

   Covid-19 will result in substantial economic damage, in much increased unemployment, in funding shortfalls for national and local government, in massive disruption in some industries, in an existential threat to cultural organisations and in the collapse of some programmes and charities providing interventions for poverty, mental health and other disadvantages. According to The UK's Children's Society, around 4 million (almost a third of children) in the UK live in poverty - and that was before the effects of Covid-19. The inequality that comes from racial prejudice and discrimination is receiving overdue attention, triggered by images of a killing by police, leading to violent demonstrations in the US and Europe.

   Wage levels are one indicator of inequality. Since the financial crisis there has been a strengthening of the positions of remuneration committees and shareholders in attention to pay differentials. But progress is slow. It seems that companies and their shareholders are powerless to make a dramatic impact. Although, about a year ago, there was some reduction in the ratio between the highest paid executives and the rest of the workforce in the UK, the median FTSE CEO reward package was still 117 times bigger than that of a worker on a median salary. It also seems that in the UK the gender pay gap is reducing only very slowly. These disparities are brought into particular focus by the low pay of health workers, risking their lives caring for those who catch the virus. In questions of pay, the market rules. And the market is generally self-interested. Unless business restores its legitimacy around equality, the market economy may struggle to survive.

   But this is not just about pay. Many companies are committed to improving diversity of all sorts. But meaningful progress is again slow. Shocking events, such as in the US, bring new resolve to organisations to deal with the issue. It is important that stakeholders hold them to

account. This is especially true for major investors, as owners or managers of capital, consistent with their ESG criteria.

Reducing inequality is about many things. It is about early stage interventions for young people. It is about access to education, to the arts, to technology and to good public services. It's about fairness and equality of opportunity. And it's about communities and the common good. The risk of getting it wrong is a divided and unstable society, with significant risks for business. This is not only a matter for government.

3. **The Environment and Sustainability**: In 1950 the world's population was 2.5 billion. In 2019 it was 7.7 billion. And by 2050 it is forecast to be 9.7 billion, with some reduction in the rate of growth in Europe/developed countries. Continued population growth presents challenges for sustainable development and the fair and sustainable use of resources. Science, such as crop science (including genetically modified crops) may buy time. Do boards take time to talk about humanity's interdependence with the natural world and the risks business runs with playing with nature in this way? What in the contexts of different businesses are the reasonable expectations of investors and other stakeholders, notably as regards climate change, the direct and indirect use of fossil fuels, extinction, rising sea levels, waste, plastics and packaging. How does a company measure the damage it does to the natural world? How does a company measure the risk? How does a company best engage openly and meaningfully with its stakeholders on these issues?

   This is the wake-up call. Expectations for business are changing. Young people, the future customers, are gaining voice. The owners and managers of capital are waking up to their stewardship responsibilities. Effective responses to the big risks, and to the major issues facing society, require management, at its most responsible, to be thoughtful, forward-looking, brave, open and agile. Management teams and Boards should look widely for ideas and advice, including from investors, employees, suppliers, customers and other stakeholders. Technology has made engagement much easier. It is the time for collaboration, not to be defensive and internally focused, hoping the problem will never emerge, or will go away, or leaving it to someone else. No one company can have all the answers. It is the time for inclusive leadership and for taking the initiative.

Sir Anthony Salz

Sir Anthony Salz sits at the intersection of British and European business and law. After over thirty years as a corporate lawyer for Freshfields Bruckhaus Deringer, the last ten as a Senior Partner, he joined Rothschild in 2006 and served as an Executive Vice Chairman until 2017. Sir Anthony was previously Vice Chairman of the BBC and has chaired a number of reviews, including on Barclays PLC's Business Practices, on Youth Crime and Antisocial Behaviour and on Press Regulation.

Footnote 1. UK Companies Act 2006. Section 172

172 Duty to promote the success of the company

(1)A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to—

(a) the likely consequences of any decision in the long term,

(b) the interests of the company's employees,

(c) the need to foster the company's business relationships with suppliers, customers and others,

(d) the impact of the company's operations on the community and the environment,

(e) the desirability of the company maintaining a reputation for high standards of business conduct, and

(f) the need to act fairly as between members of the company.

Footnote 2.

In summary, the Goals are: no poverty, zero hunger, good health and well being, quality education, gender equality, clean water and sanitation, affordable and clean energy, decent work and economic growth, industry, innovation and infrastructure,reduced inequalities, responsible consumption and production, climate action, life below water, life on land, peace , justice and strong institutions, partnerships for the goals