Spotlight on the S in ESG: Stakeholders, risk and the cost of capital

July 27, 2020

By Heather Wilson, Director, Research Services

For many years, the "social" in environmental, social and governance (ESG) discussions has taken a back seat to the other elements, but that subordinate role appears to be changing and directors are taking increased notice of the 'S' factor. Issues brought to the forefront by the recent pandemic, as well as the current civil unrest, have highlighted the need for directors to be prepared for the impact on their organizations of important social issues.

In a recent interview, Faith Goodman, CEO, Goodman Sustainability Group Inc., observed that the 'E' in ESG has played "an outsized role in board and C-suite conversations in the last several years, followed by the 'G' and, the 'S,' a distant third." This is perhaps understandable as companies, when motivated, were able to identify their firms' effect on the environment, adapt existing environmental measuring and reporting frameworks and, finally, develop disclosures that communicated their environmental impacts to investors and other stakeholders.

There isn't a similar level of consensus on what the 'S' should encompass. The 'S' is becoming an initial proxy for measuring the overall quality of an organizations' leadership, a barometer of corporate culture and the resulting fair treatment of stakeholders. The range of topics include (but are not limited to): human rights, labour issues, workplace health and safety, data, social justice, product safety and others. Indeed, some have argued that the word "social" is too amorphous and unhelpful as companies try to assess their exposure to potential social risks. Using the word "stakeholder" may be a more useful way of understanding the issues by helping companies look at who is impacted by their actions (or inactions).

The impact on each organization is often difficult to identify, define, compare and measure – and, may only be fully realized when something has gone wrong (recent examples include Goya and Facebook). Stakeholders are also, according to Goodman, increasingly looking at corporations and determining if they demonstrate transparency, consistency, truthfulness and credibility. This may be especially true for Millennials and other younger generations who seek to align their values with the organizations they work for and transact with. Goodman also notes that companies with a clearly-articulated and “lived” purpose, along with an integrated ESG framework, will gain the trust of stakeholders – including investors – and this is a catalyst for long-term competitiveness.

A growing body of global stakeholders believes that the risks posed by social issues may be the most significant for organizations and therefore require the board’s full attention. According to Goodman, social issues are such an important challenge that boards “ignore them at their peril given brand-risk implications.” The need for increased consistent disclosure of all ESG metrics is also demanding that organizations develop the appropriate tracking and communication materials that include social impacts. A recent GAO report notes that institutional investors are looking to companies to provide ESG disclosure which allows them to properly assess risk. The report advises that the inconsistent quality of the disclosure is harming investors’ ability to adequately assess potential ESG impacts, and that more needs to be done to improve the consistency and value of the disclosure provided.

This focus on the ‘S’ in ESG began before COVID-19, but the global pandemic has amplified the urgency of that attention and allowed directors to see how complex and potentially risky social issues can be for their organizations. Appropriate direction and oversight are required at the board level. Third-party scrutiny has increased and may be contributing to the mounting pressure on boards. Directors will want to ensure that their understanding of ESG includes the social issues that impact the key drivers of their business, as well as any that represent a significant risk.

Goodman notes “that if nothing else, boards need to take serious note that the cost of capital is higher for companies without strong ESG/sustainability performance. Indeed, we are experiencing a momentum shift in the reallocation of capital, as private equity firms and others direct significant capital to companies with strong ESG. This shift has the potential to cast a shadow on the corporate survival for some firms that do not comply. Companies who master ESG will enjoy access to lower cost capital, and will have greater capital inflow options. This is a compelling competitive advantage, and boards would be ill-advised to dismiss the speed and magnitude of this evolving ESG reality.”

Boards have a critical role to play in ensuring the long-term sustainable success of their organizations. This includes paying sufficient attention to the social issues which may represent an existential threat if not properly monitored and acted on when appropriate.

Source: Director Lens Communique July 27, 2020