Unravelling the conflicts in 'Double Materiality'

Where do you draw the 'moral' line and how do you have a genuinely positive impact?

The mandates of most investment institutions are expressed in terms of a single materiality: to secure the best realistic financial return over the long term given the need to control for risks. These risks are deemed to be financial risks. Environmental, social or governance risks can be incorporated when considered in financial terms: causing environmental degradation; poor treatment of customers, suppliers and employees; or poor governance might risk a company's brand value and incur legal or regulatory penalties and other financial costs.

But the EU Sustainable Financial Disclosure Requirements (SFDR) and other new regulations and reporting requirements have opened-up another dimension, a 'double materiality', requiring investors to disclose the adverse impacts of their investee companies on people and planet. These are wider considerations than purely financial ones. Single materiality considers the impact of climate change on the company; double materiality considers the impact of the company on climate change.

Disclosure of the 'adverse impacts' or harm caused by companies is a critical step in tackling the systemic risks, like climate change, that society faces. Investment institutions have a part to play – increasingly they will be expected to invest 'sustainably' across all their mandates, in other words in a manner that supports a healthy society in future in which the fund beneficiaries can spend their savings or pension. As the United Nations Brundtland Commission put it in 1987: "meeting the needs of the present without compromising the ability of future generations to meet their own needs".

Many institutional investors are still grappling with how to manage these wider concepts and conflicts and to integrate sustainability into their decision-making. How do you manage adverse impacts? Do you divest?

How does an institutional investor create a positive impact?

The divestment debate will continue to rage and, reflecting strong views among their beneficiaries, some institutions have divested from fossil-fuel companies. A key argument against such divestment is that it does nothing to address climate change – ownership of the shares transfers to someone else who may not be as concerned about the issue.

Also, as shareholders institutional investors are in a uniquely powerful position to generate positive impact. Who is accountable for the

carbon emissions of a company? Ultimately the owners appoint the directors and managers that decide how the company operates. Institutions are still very timid in holding the leaders of the companies they own to account: voting data from Proxy Insight for 2020 shows that only 3.4% of director re-election proposals worldwide received less than 80% support[1]. Only 0.3% of director appointments failed to receive majority support. But if the company board fails to address the social and regulatory risks of climate change, directors should be held accountable. If the accounts fail to reflect decarbonisation risks, directors that sit on the Audit Committee should be held accountable. If the auditor fails to point out potential misrepresentation in company accounts, the auditor should not be reappointed.

Weak oversight by investors not only leads to low career risk for company directors, their remuneration has reached extraordinary proportions, linked to the 'single materiality' pursuit of profit maximisation. In 2020, only 12.5% of advisory pay votes on executive remuneration received less than 80% support.

As policymakers search for solutions to the world's environmental and social problems, institutional investors are in their sights: one aim of the COP26 conference is the "mobilisation of private businesses and finance to support these objectives". Given the urgency ("code red for humanity") to find solutions, there may be little time to lose for institutional investors to show they are playing their part. To that end, Sarasin & Partners recently led a coalition of institutional investors and advisers, representing more than $2.5 trillion of capital, in writing to Alok Sharma, president of COP26. We asked for heads of state to set a clear timeline for companies to produce accounts consistent with limiting global warming to 1.5°C above the pre-industrial level, and for auditors to call out where they don't.

Ultimately, the purpose[2] of business is to solve the problems of people and planet profitably, and not profit from causing problems. Regulations requiring the better disclosure of adverse impacts, and the better recognition of sustainability, will expose the long-standing criticism of institutions failing to fulfil their ownership responsibilities. Let us hope that double materiality will catalyse significant change in how capital is allocated: in the end we all share one planet and ignoring this very important fact could lead to our collective undoing.

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FOOTNOTES

1 Proxy Insight Annual Review 2020 https://www.proxyinsight.com/wp-content/uploads/dlm_uploads/2020/12/Proxy-Voting-Annual-Review.pdf

2 Principles for Purposeful Business 2019 British Academy https://www.thebritishacademy.ac.uk/documents/224/future-of-the-corporation-principles-purposeful-business.pdf

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