Measuring the ‘S’ in ESG Related to Modern Slavery

MEKONG CLUB

FIGHTING THE BUSINESS OF SLAVERY

Index

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ESG Investment

ESG investment is a strategy that seeks both financial and social returns by assessing the environmental, social and governance activities and policies of a company. It is a set of declared standards, policies and goals for a company's operations that socially conscious investors can use to screen potential investments. These investors are often referred to as Socially Responsible Investors or SRIs. Applying these criteria is becoming mainstream, as retail and institutional investors apply moral codes to their investment decisions.

Environmental criteria look at how a company operation impacts the environment. Social criteria examine how a company manages relationships with its employees, suppliers, customers and the communities where it operates. Governance deals with a company's leadership, executive pay, audits, internal controls and shareholder rights.

The term was adopted in 2005, and the strategy began to be used around the 2008 financial crisis, long after socially responsible investment first became a trend. ESG has grown 76% in the last five years, reaching a quarter of the global assets under management (US$80 trillion) today[1].

The significance of an ESG strategy is evidenced by the interview results of more than 400 mainstream senior investment professionals. They cited positive investment performance as the main reason for using ESG data, followed by client demand and product strategy[2]. With a quarter of global asset managers now basing investment decisions on ESG factors, an ESG strategy has the ability to reward and shape company policies and positively impact social and environmental issues.

Take, for example, an investment that is carried out based on environmental factors such as climate change, forests and water. The Carbon Disclosure Project provides a platform and a framework for companies to report. With 5,500 companies reporting according to the same standard, it enables asset managers to analyse and compare the companies. This allows for a practical research process in making investment decisions instead of referring to multiple sources, and it also motivates companies to report according to these standards. With such structure in place, investors and companies together are able to achieve scale in helping to address these environmental issues.

To date, the focus within the investment world has largely been on the environmental ('E') side, with extensive research having been done into certain products and their possible effects on the environment, from global warming to deforestation. As the conversation begins to focus more on the social ('S') side, the Mekong Club is observing increasing research and trends that signal the importance of investment based on related issues including modern slavery.

There are several trends that support the need for further modern-slavery-based investment, including the financial risk of not acting, as well as the growing relevance of millennials for whom slavery is a major 'red light' issue. Companies are starting to understand that environmental and human-rights scandals cause profound financial and reputational damages. This is evidenced by BP's 2010 oil spill and Volkswagen's emissions scandal, where the share prices of those companies suffered tremendously and resulted in billions of dollars in associated losses. BP's stock fell by 51% in 40 days on the New York Stock Exchange, a dramatic downturn on 20 April 2010 from $60.57 to $29.20[3]. Furthermore, studies reveal that the sweatshop scandals resulted in an average loss of US$60M per bad news that was exposed[4].

Millennials are a significant part of the investment community with the power to shape trends; they are set to inherit approximately US$30 trillion of assets from the baby boomers in the next decade[5]. They align their investments and purchasing decisions with companies practising positive ESG impact, especially human-rights values[6]. From the financial risks to the expectations of millennials, it is imperative that investment based on human-rights considerations is encouraged.

In order to increase the investment based on 'S', these trends must be seriously considered, and NGOs must step up to offer their expertise to both corporations and investors so that specific indicators can be defined. Identifying potential indicators of slavery is a challenge, and it is only through public-private collaboration that systems and processes can be standardised and scaled.

Defining the 'S' in ESG for Modern Slavery

Typically, each stream of ESG includes a set of indicators that necessitate careful attention to related issues. The 'E' stream includes biodiversity, carbon emission, energy usage and water management; 'S' focuses on modern slavery, child labour, diversity, employee relations, human rights, health & safety and human capital management; and finally, 'G' addresses board structure, executive compensation, ownership structure and shareholder rights transparency.

Modern slavery is one of the most underweighted indicators of the 'S' stream because it is currently the least quantified, and therefore attracts minimal investment. Asset managers either invest passively in an index or a fund that packages companies together, or actively into a specific company that aligns with their ESG values[7]. The active investment pays close attention to market trends, economy, political landscape and factors that may affect these companies. The problem is that both approaches do not weigh the modern-slavery indicator as much as others in the ESG streams. By creating a set of clear and standardised indicators, the Mekong Club is seeking to leverage the current momentum of ESG investment and increased capital flows to help eradicate forced labour.

Appreciation and understanding of the real risk associated with inadvertent exposure to modern slavery has become more prevalent in the investment world, and this has raised the demand by socially responsible investment funds for more data analysis. It is important for investment companies to support corporations that adhere to a strict, no tolerance policy related to modern slavery. Investments in corporations that work within sectors that have a potential material risk should be carefully assessed. This includes ensuring adequate policies and procedures are in place to identify and address modern slavery within supply chains.

An effective ESG strategy requires clear indicators that facilitate the investment process and enable accurate analysis. Today, the 'E' and 'G' elements offer quantifiable indicators/metrics such as the Carbon Disclosure Project and Newsweek's Green Rankings. The effectiveness of existing indicators and metrics is evidenced by the fact that the majority of ESG investment is based on 'E' and 'G' rather than 'S', which is the least understood.

'E' continues to step up its reporting efforts by creating the Task Force on Climate-related Financial Disclosures – a working group creating a comparable and consistent reporting system that enables companies to disclose their climate-change initiatives to their investors.

At present, there are no standardised criteria for measuring social factors related to modern slavery. A recent study by Harvard Kennedy School states that ‘S’ is “seriously under-conceptualized and fails to draw substantive and procedural human rights standards”. ‘S’ lacks quantitative indicators and national standards that exist in ‘E’ and ‘G’[8].

Furthermore, ‘S’ is not investor focused, meaning it lacks quantitative indicators. An NYU study that gained access to 1,700 ‘S’ indicators across 12 reporting frameworks found that only 14% of ‘S’ ratings targeted investors as the primary audience, versus 97% of ‘E’ and 80% of ‘G’ ratings[9].

The principal participants within the ESG ecosystem are companies, sustainable reporting frameworks (such as SASB and GRI), data providers and asset managers. Companies report their sustainable activity according to the framework of their choice. Data providers calculate the ESG score with these reports as one of the data points. And asset managers invest based on a combination of this information, reports from NGOs and experts, and their own due diligence.

Data providers such as Bloomberg, Reuters and MSCI report ESG data on approximately 10,000 companies. The fact that each provider references a different set of information creates a large set of non-standardised/scattered data. Major asset managers such as BlackRock, J.P. Morgan, Merrill Lynch, Goldman Sachs and State Street now offer ESG funds made up of various asset classes including equity, fixed income, alternatives, real estate, private equity, etc.

This growing number of stakeholders makes it imperative to work towards standardisation of the indicators. The current dilemma of non-standardised and non-quantified indicators has resulted in modern slavery being the most underweighted of all the indicators within the ESG framework.

Why are Modern-Slavery indicators necessary?

The first reason why modern-slavery indicators are necessary is that they improve the risk profile of the asset manager’s portfolio. The consensus among investors is that currently available indicators on human rights are non-standardised and vague. This makes it difficult to invest based on this particular issue, so an opportunity to protect their investments is lost. It is well documented that human-rights violations create catastrophic outcomes to the bottom line, and this requires careful analysis and attention by investors so as to avoid this risk.

The second reason is that creating the necessary tools/indicators will facilitate the investment process and in turn reward and recognise both the companies and investors. This will also motivate other companies to implement effective ESG policies.

Increasing legislation around ESG reporting is another factor that needs to be considered. United Nations Principles for Responsible Investing states that 72% of countries have mandatory regulations on disclosure of sustainability issues[10]. Furthermore, 42% of countries advise or require pension funds to consider ESG factors[11]. Exchanges are also requiring companies to report on issues such as workplace health and safety, forced or child labour in supply chains, and efforts to combat corruption. Hong Kong regulators and government funds are requested by the Hong Kong Financial Services Development Council to scale up ESG integration investing in order to be aligned with global trends[12].

Against this background, the Mekong Club launched the ESG Project to facilitate investment based on human rights.

The Practical Steps

The cornerstone of the Mekong Club’s ESG Project is the development of its own slavery indicators. This will be done in collaboration with key stakeholders, including corporations and data providers.

The Mekong Club has developed an initial set of modern-slavery indicators. These indicators have formed the basis of private-sector training on the issue of modern slavery. They were also drawn from internal practices that companies have been advised to implement from within their own organisations. In effect, the first step was to develop a baseline of ‘best practice’ from the existing corporate world.

These indicators have proven to be an effective way to create change and have already led to victim identification within supply chains. These evidence-based indicators will be further refined based on further input from stakeholders in order to arrive at a set of quantified and refined forced-labour indicators.

Our vision is that this will enable the investment community to make a tangible impact upon supply-chain slavery through better-informed investment decisions – in turn, motivating companies seeking investment to improve their ESG practices.

Increasingly familiar human-rights atrocities in supply chains must stop, and we at the Mekong Club feel that this is a critical moment in time to take the initiative and launch this project. Asset managers really have the power to influence companies, and thereby help save modern-slavery victims.

The following table provides a sample of standardised questions that investors can ask regarding a company’s existing processes and procedures. Depending on the situation, all or a sample of questions can be selected. Over time, a similar set of questions will be standardised and used across the investment community.

Understanding

- Does the company distribute modern-slavery awareness materials to staff?
- Does the company train staff and stakeholders on relevant modern-slavery topics?
- Does the company ensure that internal departments exposed to the risk of modern slavery receive advanced training and capacity building?

Commitment

- Does the company have a committee, team, or officer responsible for the implementation of its supply-chain policies and standards relevant to modern slavery?
- Does the company have an internal code of conduct, policy or related document that states its policy on modern slavery?
- Does the company have a public policy statement/commitment on fighting modern slavery?
- Does the company have a procurement/purchasing policy that includes references to modern slavery?
- Does the company have a written policy related to migrant recruitment within partner suppliers (fee free/one-month fee, etc)?
- Does the company request its suppliers to sign contracts/sub-contracts that include anti-slavery clauses?
- Does the company have a policy that covers remediation of labour violations?

Action

- Does the company require its first-tier suppliers to ensure that their own suppliers implement standards that are in line with the company's policies addressing modern slavery?
- Does the company assess the risk of forced labour within potential suppliers before entering into any contracts?
- Does the company map its procurement supply chains to understand where there might be risk of modern slavery?
- Does the company conduct social audits on suppliers that assess issues relating to forced labour?
- Does the company have the ability to investigate, cooperate and provide remediation for forced-labour violations that have been identified?
- Does the company have a procurement process that considers the capacity of suppliers to meet fluctuating demands? (e.g. to reduce risk of undeclared sub-contracting.)

Leadership

- Does the company provide corporate support to NGOs fighting slavery, including donations, fundraising and/or in-kind contributions?
- Does the company promote multi-stakeholder cooperation aimed at action against modern slavery?
- Does the company disclose information and data gathered through audits, research and ad-hoc investigation either publicly or within the business community?

About the Mekong Club

The Mekong Club is one of the first not-for-profit organisations of its kind in Asia to use a 'business-to-business' approach to fight modern slavery. Bridging the gap between the public and private sectors, the Mekong Club helps companies of all sizes to understand the complexities of modern slavery and to reduce their vulnerability within their supply chains/business environment. Together with business partners, the Mekong Club is spearheading innovative and strategic projects to achieve a slave-free world.

The Mekong Club acts as a catalyst for change – engaging, inspiring and supporting the private sector to take a strong lead in the fight against modern slavery.

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