The Critical Role of Institutional Investors in Ensuring Emphasis on ESG Principles

Bharat Wakhlu
Resident Director
Tata Services Ltd.

The term 'Investor' is a generic one, given to any individual or legally recognized person who commits funds and other financial resources into an enterprise with the intention of getting a good return on the assets in a reasonable period of time. Investors therefore include high net worth individuals, pension and insurance funds, banks, private equity firms, governments and all others organizations and Institutions that park their funds and other resources into businesses. The term **ESG Principles**, refer to the **Environmental**, **Social** and **Governance** criteria that form the bulk of the non-financial factors used to assess the sustainability and the ethical impact of investments in companies and enterprises.

Throughout history, investors have sought to deploy their financial assets into those businesses that give them the greatest returns, with the least perceived risk. This has been an overarching focus of investors – singly and collectively - since the beginning of the era of bodies corporate, sometime in the middle ages. The same thinking has prevailed with most investors throughout the centuries as well. Quite naturally therefore, **investor priorities** have been a prime-mover in determining the behavior of the Managers/Owners of enterprises, and thereby of corporations since the 17th century. **Therefore, what the investors want from their enterprises, in addition to a reasonable return on their assets, and what they endeavour to measure, monitor and demand the business to be accountable for, gets done.** All else is usually given short-shrift.

It does not require too much analysis to come to the axiomatic conclusion that if investors are concerned ***only*** about their returns, and pay no heed whatsoever to ***how*** the enterprise runs its business, such companies can go completely 'out of control'.

What do I mean by investors heeding '*how*' the enterprise functions? If investors remain oblivious to, or consciously turn a blind-eye to matters such as how the firm deals with its many interfaces - that are legitimately required for the effective running of the enterprise – and which include, among other areas, how the enterprise secures raw materials, employs people, engages with communities impacted by their operations, or uses land and water resources, then the firm can go about doing all that the business requires - without let or hindrance - with the primary goal of maximizing the returns to its shareholders' investments. However, in the process of pursuing the singular goal of profits, the company can **mismanage** or wilfully **disregard** critical and important interfaces; but since the enterprise is not accountable to its investors – or their representatives – on matters related to how these interfaces are managed, they can, literally get away with anything.

Many of you might question this line of thinking. You might suggest that regulations and the writ of governments, and the presence of laws are meant to oversee the functioning of enterprises, and prevent them from 'going overboard' in their pursuit of profits for their shareholders. This is indeed the intention of sound and enforceable regulations. But compliance with the rules and adherence to laws are no substitute for enlightened **self-governance** by the key shareholders of an enterprise. The process of enforcement of laws and assuring adherence to regulations is a **reactive** effort by a third party, whereas self-governance is a **proactive**, **forward-looking** enabler by a first party for long-term effectiveness of the enterprise in which they own stake.

It is worthwhile at this stage to give an example from history. The East India Company was given a Royal Charter as a joint-stock company by Queen Elizabeth of Britain in December 1600. The company was not owned by the government, but by aristocrats and wealthy British merchants.

All of them were keen to grow their investments on the budding trade in commodities, spices, tea, opium and indigo that had started between India, China, Indonesia and Europe. In the early days the company started to engage with the local rulers within the territories where they established a trading presence. However, the distance between England and the 'Indies' and the complete disregard of the investing merchants for the manner in which the company secured its profits, resulted in the creation of a private army by the company (by now called 'Company Bahadur' in India!). This army, paid and stocked entirely from the East India Company's resources, managed to secure monopoly trading and other profit-making rights for itself, and ruled much of India from the 1700s to 1857. The merchant investors, who started off by receiving their dividends in the form of sacks-full of pepper-corns in the early years, were thrilled that latter-day dividends started to come to them in the form of gold coins minted in India!

History is replete with countless other examples of corporations going completely overboard in their endeavor to make profits. In fact the juggernaut of international maritime trade and the desire of nations to grow economically from the 17th century onwards, brought about serious violations of the rights of communities, and smaller nations. The abhorrent practice of slavery – between Africa and the US - was fuelled by the greed of enterprises and their investors, the lack of regulations and of laws banning trade in humans.

The good news however, is that even in earlier centuries, there have been investors who have placed their funds into businesses, on the basis of ethical and financial criteria. The Quakers, the Free traders and the abolitionists were among them. In 19th century Britain, investors such as Robert Owen, William Lever and John Cadbury also encouraged businesses to be run in ways that were socially responsible, and took care of the rights of employees, and the neighboring communities. Closer home, in the 20th century, Jamsetji Nusserwanji Tata – on the lines of some of the early European pioneers – demonstrated that investing in socially responsible businesses was not a strain financially, but actually created wholesome bonds with people and opinion makers, that stood the business in good stead. Many investors have also consciously stayed clear of businesses that offer 'sin stocks' { that is the businesses are into alcohol, gambling, firearms, and similar 'inappropriate' lines}, and have gone through a thorough process of due diligence before investing, in order to ascertain if the **Environmental, Social** and **Governance** (ESG) standards are met.

The world has changed considerably over the past few decades. Climate change is real, and is attributable to anthropomorphic activity. Upholding and protecting human and animal rights is now a given. Environmental degradation cannot be allowed, since businesses cannot subvert life itself. Communities and consumers are demanding more transparency in the ways businesses function, so that people can be assured that their rights are not adversely affected. **Profits today, have to be matched with even more concern for people and for our planet.**

If you go back to what I have emphasized in the second paragraph of this piece, it is clear that Institutional Investors therefore have an immense responsibility. Investors will have to seek companies that are committed to fulfilling their Environmental, Social and Ethical (Governance) responsibilities at all times, and then decide to invest in only such enterprises. Not only should the companies use a 'check-box' system to demonstrate compliance to ESG principles, but should have embedded processes within the enterprise, that enable socially and environmentally responsible decision-making to become a part of the way business is coducted. In fact, this is even more so in this day and age, since business boundaries go well-beyond the traditional walls of the factory, and extend all the way to other geographies, on account of long and complex supply chains. No longer can investors turn a blind eye to the manner in which a global enterprise sources talent or raw materials from other parts of the world. If it is not being done appropriately – and sometimes the local regulations might not consider the lower standards a violation of the laws of the land – the investor would do well to raise the bar for the company, and ensure that what is globally considered ethical and appropriate, and is in alignment with ESG principles, is adhered to. With this being demanded by institutional and other investors, companies will begin to behave in socially and environmentally responsible ways. Such a trend is good for people, the planet and for profits in the long-term.

Before investors think of ESG due-diligence as yet another 'troublesome burden' for them, there are data to show that investments in companies that are committed to ESG compliance fare better in giving returns to investors. Besides, the investment market is actively looking at ESG criteria in evaluating prospective companies in which to park funds. Any institutional investor, not doing so, is unlikely to gain access to such a market in the first place.

For Indian investors, the challenge to seek the right businesses that are committed to upholding their Environmental, Social and Ethical responsibilities is even greater. This has a lot to do with the fact that India is a nation with a population of close to 1.27 billion people (2014), with an average population density of 390 per square km. This is way beyond the world average of about 47 per square km. Given the topography of our country, business establishments and 'brick and mortar' factories and manufacturing facilities are bound to be in close proximity of or adjacent to urban and rural centers, forests, wild-life habitats, rivers, water-bodies and arable land. Therefore, businesses will consciously have to ensure that at all times they contribute to the following, four life-affirming principles, namely: a) **Environmental sustainability**, b) **Social justice**, c) The **spiritual well-being of people** and d) **Economic well-being with an enhanced quality of life for all**. Investors, in turn, would be contributing to the well-being of businesses and the nation if they encourage the adoption of, and then measure and monitor ESG compliance and processes. What institutional investors seek and demand, businesses are bound to deliver.

The times we live in call for businesses to be completely aligned with the four life-affirming principles mentioned above. Businesses on their own might adopt these progressive principles, even as they endeavour to give their investors a fair return – as we saw Jamsetji Tata do in the late 19th and early 20th centuries. But not all businesses would on their own do something that bucks the trend of 'focusing only on profits'. Government regulations and investors can goad such businesses to change the way they function.

Institutional investors in particular, bring in the financial heft, a broader understanding of the triple bottom-line (people, planet and profits) and have formalized processes of engagement with the Managements/Owners of enterprises to guide them into ESG compliance. That alone will ensure that sustainability and ethical practices become the norm for running enterprises, and people begin to look at firms and businesses as trustworthy, and socially and environmentally responsible engines of long-term well-being and beneficial change.

Bharat Wakhlu has been with the Tata Group for over three decades, and has served in a variety of senior positions in different Tata companies. He can be reached at bwakhlu@gmail.com