ESG implications of the COVID-19 pandemic

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Key risks

The value of investments and any income derived from them can go down as well as up as a result of market or currency movements and investors may not get back the original amount invested.

The global coronavirus pandemic is an unprecedented global crisis. The human, economic and financial impacts have already been huge, and it is not yet clear how quickly the virus will be brought under control and normal economic activity can resume.

BMO GAM's Responsible Investment team has been considering the impact of the coronavirus on the ESG agenda. We are co-operating with other investors to provide companies with a united message on our expectations of how they should respond – we have co-signed the Investor Statement on Coronavirus Response[1] and would encourage other investors to do the same.

With the rapidly-developing situation, we are still in the early stages of understanding the impact that COVID-19 will have. However, some important implications are already emerging.

Company attention to sustainability issues

Our engagement is aimed at elevating the importance of sustainability issues at companies, and where possible, at getting Board-level attention focused on them. With companies rightly focused on the immediate crisis, it is likely to be difficult to get Boards to spend time on sustainability topics.

Our engagement will be respectful that priorities have changed, but we will also aim to ensure that sustainability issues are not forgotten, and that companies continue to make progress where they can. Even in a time of short-term crisis, we need to keep our eyes on the long-term investment horizon.

Although in-person meetings with companies are not currently possible, we are otherwise continuing to engage as usual including through video conferencing and

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[1] http://domini.com/covid19-statement

phone calls, in line with our engagement priorities set out at the start of the year. We fully understand, though, that some companies may not have the capacity at present to discuss ESG issues with shareholders. At the time of writing, we have had one company inform us that they are postponing all non-essential shareholder dialogue, and we expect others will follow.

Impact on staff and wider stakeholders

An urgent priority for companies is to address employee concerns over sick leave, quarantine and caring responsibilities, recognising that disruption may last for months to come. The scientific evidence is clear that self-quarantine measures are essential in controlling the spread of the virus, and companies bear a responsibility to enable this where they possibly can.

Best practices will vary by sector, but include:

- Provision of protective gear and high-frequency cleaning for workers who are exposed to contact with people in their jobs
- Introduce or extend sick leave provisions, especially in jurisdictions where this is not the norm or mandated by government policy
- Flexible shift work for those not able to work from home/remotely; flexibility and adjustment in expectations for home-working staff who are impacted by childcare closures
- Emergency funds or salary guarantee for a period of time for staff who are temporarily not required due to business closure or lockdown
- Provision of mental health support

We are already seeing significant gaps opening up between companies which are doing a good job of looking after their staff and those which are not, with social media very active in calling out the latter; companies neglecting their responsibilities now may face consumer hostility later.

Linking up with our wider engagement on workplace standards and diversity, we are already seeing that those companies that have embraced a culture of flexible working will have less productivity loss than those that haven't. We would hope that many of the lessons learned now from enforced working from home will be lasting ones, and facilitate more flexible working practices and shared childcare in future.

As well as their employees, companies also have responsibilities towards wider set of stakeholders including their suppliers and customers, many of whom are also facing enormous strains. Respecting these responsibilities and doing what they can to alleviate the problems will be important in maintaining and building these relationships in the longer term. Measures that companies can take include ensuring that suppliers are paid on time, or even ahead of time; making their products more easily accessible to vulnerable customers (both in terms of affordability and physical access, such as offering deliveries); and philanthropic activities to support the most impacted communities.

Company Annual General Meetings (AGMs)

With mass gatherings discouraged or banned in many parts of the world, in-person company AGMs will largely no longer be possible. We have been speaking with companies about their contingency plans, with options including delaying or postponing the meeting, moving to a hybrid (part physical, part virtual) AGM, or where permitted, a virtual online-only AGM.

We have already seen multiple AGMs cancelled in Finland and postponed in Germany, with further announcement pending in the coming days and weeks. This also means that dividend payments and capital raising authorities which require AGM approval will be delayed.

There are legal challenges in some jurisdictions to these changes, such as in France where companies are obliged to offer the option of in-person attendance; some governments have already waived this obligation. Some individual company by-laws may also make certain options difficult. Guidance is starting to emerge, such as a UK joint publication based on advice from law firm Slaughter & May setting out the legal position for companies.[2]

In normal circumstances we have discouraged companies from holding online-only meetings, as this undermines the opportunity for interactions between shareholders and Boards. With virtual meetings a necessity now, we encourage companies to ensure where possible that there are still opportunities to allow shareholders to ask questions to the Board. Once this crisis passes, we will encourage companies to move back to normal in-person AGM arrangements, whilst maintaining the virtual option as part of a 'hybrid AGM'. This leverages technology to allow maximum access, whilst retaining the ability to hold boards to account by providing physical attendance.

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[2] https://www.icsa.org.uk/assets/files/pdfs/guidance/agms-and-impact-of-covid-19-web.pdf

Executive pay

Many companies will miss short-term and long-term incentive plan targets given the market and economic conditions. This will have significant implications for pay awards granted to executives.

We recognise that pre-AGM engagement on this topic may not be a priority for many companies, but our team remains available for guidance or questions. We would encourage investee companies to consider the following:

- Shareholders will not generally look favourably on executives receiving generous bonuses following a year where shareholders have lost out, even though the impacts of the virus are outside of companies' control.
- We recognise that remuneration committees may make adjustments to schemes to permit rewards to executives who demonstrate exceptional skill in navigating their company through the difficult period ahead. We will pay close attention to individual company circumstances, including whether companies are consistent in their treatment of staff and executives. For example, if companies make it difficult for their workers to self-quarantine, we would look extremely unfavourably on any attempts to compensate executives for their lost bonuses.
- For companies seeing an exceptional increase in demand for their services as a consequence of the virus and of related government measures, we generally expect remuneration committees to treat this as a windfall effect and be prepared to adjust pay downwards if appropriate.

Some executives in heavily-impacted sectors such as aviation have voluntarily taken pay cuts, including a few cutting their base salary to zero. Whilst as investors we would not require such a move, if CEOs are able to make these gestures in extreme circumstances, it is likely to engender greater staff loyalty in the longer term.

Capital Allocation

One of the central pillars of corporate governance is capital allocation, and where companies decide to focus their funding. Over recent years we have seen companies using increasing amounts of cash to re-purchase stock rather than investing in their businesses or bolstering up their balance sheets. In the S&P 500, 50% of all free cash flow is now used to re-purchase stock.

At a time when balance sheets are under immense pressure and companies face significant unexpected costs, including how they dedicate resources to ensuring the welfare of their staff, management should review the appropriateness of their share buyback programmes both at this time and in the longer term.

Although there is an expectation that certain sectors will receive government assistance, the most likely outcome for distressed companies will be the use of emergency capital raising through deeply discounted rights issues or placings. In these circumstances, we would like companies to minimise the dilution of existing shareholders by honouring their pre-emptive rights and giving them the right to purchase further shares before others in the market.

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Climate change

The collapse in global economic activity will result in a short-term dip in global greenhouse gas emissions growth. One estimate put the carbon dioxide reductions resulting from China's February shutdown at 200 million tons[3], around half the UK's annual emissions. However, this is of course a temporary impact. The more significant point in relation to climate change is the impact of COVID-19 on the practical preparations and political momentum ahead of the critical COP26 climate meeting. The kind of mass climate demonstrations which were so effective last year will not be possible, and governments' attention will inevitably be distracted.

At a macroeconomic level, the International Energy Agency have also warned that the slowdown is likely to stall many government-funded green projects, as governments urgently divert resources to keeping businesses and individuals afloat. Collapsing energy demand will also have a negative impact on private sector investment; in Europe, for instance, the EU emissions trading scheme price has fallen sharply, decreasing the incentive for renewables investment. Further ahead, there may be potential for 'green fiscal stimulus' – government spending on new green infrastructure – but it is too early to say how likely this is.

With COP26 already looking challenging due to the political stance of some major governments such as the US, these further headwinds make it even more important for investors to take action, including calling on companies to align business strategies with the Paris goals, and encouraging governments to set ambitious national emissions targets.

Public health

The unprecedented pressure on healthcare systems reinforces the rationale for our work on antimicrobial resistance (AMR) and access to medicine strategies, including responsible drug pricing.

Antibiotics are not effective against viruses such as COVID-19. However, they may be used in the treatment of some complications from the illness, like pneumonia. If antibiotics continue to lose their effectiveness, vulnerable patients may be at increased risk of worse clinical outcomes and death from this pandemic, and those which may come in the future.

In relation to access to medicine and responsible drug pricing, the current crisis highlights the need to ensure that vaccines preventing infectious diseases as well as effective treatments are affordable for all, regardless of geographic location. Public health systems are under huge strain, and companies need to work constructively with governments to ensure equitable access to treatment is possible.

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[3] https://www.washingtonpost.com/climate-environment/2020/03/06/coronavirus-could-halt-worlds-emissions-growth-not-that-we-should-feel-good-about-that/?arc404=true

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