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Stakeholder Capitalism – Unlocking Tomorrow's Opportunities

As business leaders continue to grapple with the ongoing repercussions of the pandemic, they are taking deliberate steps to plan for a new reality. Some are focusing on the immediate challenges with how to return to work and how to address the newly uncovered vulnerabilities in their business while others are asking existential questions about the fundamental purpose of business. Is their business model aligned with the needs and expectations of their customers? Do employees see the relevance of their work in society at large? Do investors believe their environmental, social and governance (ESG) strategy is credible?

Leaders are challenging the doctrine rooted in Milton Friedman's teachings that "the purpose of business is business" and that the only responsibility of business is to engage in activities designed to increase its profits for the benefit of shareholders. They are seeking ways to adapt by allowing capitalism to become a catalyst for resolving significant societal and environmental issues that threaten the lives and livelihoods of their employees, customers and society at large. This new "stakeholder capitalism" is becoming mainstream as leaders acknowledge their ability to deliver value to all participants in their value chain; customers, employees, suppliers, shareholders, and society.

This first article in a series will provide background on the narrative around the purpose of business. A business case for ESG is presented which identifies how a commitment to the betterment of our environment, society and governance is not at odds with profitability, and, if executed successfully will lead to superior near-term revenue and long-term value creation. Future articles will expand on specific ideas validated by experiential evidence for aligning purpose with financial results, including development of public private partnerships, design of network effects, focus on shared value creation, and innovation of commercially viable, socially impactful solutions.

Narrative Around Purpose: In the 1970s Milton Freidman wrote that "the only social responsibility of business is to engage in activities designed to increase its profits." Aside from obeying the law, Friedman professed that Management and Boards are exclusively responsible to their shareholders. Although highly debated among scholars and business leaders, Friedman's mantra, that "the purpose of business is business" remained mainstream until the early 2000s.

In January 2004, the UN Secretary General Kofi Annan wrote to over fifty CEOs of major financial institutions, inviting them to participate in a joint initiative aimed at finding ways to integrate ESG factors into the capital markets. A year later this initiative produced a report entitled *Who Cares Wins*, which made the case that recognition of ESG factors by capital markets makes good business sense and leads to more sustainable markets and better outcomes for societies. Four of the twenty-three endorsing institutions were global insurance companies. In 2006, the UN launched its "Principles of Responsible Investing" (PRI) which recognized ESG considerations as a proxy for responsible investing to enhance returns and better manage risk. While voluntary and aspirational, PRI gained increasing support following the 2008 global financial crisis when markets began to recognize that ESG goals, such as climate change and human rights, can affect the performance of investment portfolios and should therefore be considered alongside traditional valuation metrics.

These discussions were largely driven by the investment community until 2019 when the Business Roundtable, a non-profit organization composed of two hundred CEOs of major U.S. companies, released a statement redefining the purpose of a corporation: to promote a new economy for the benefit of all stakeholders including customers, employees, suppliers, communities, shareholders, and society at large. Today mega trends such as “hyper-transparency,” “stakeholder activisms” and “societal expectations” are catalytic forces driving leaders to prioritize ESG factors. Leaders are seeking ways to balance short- and long-term business pressures in order to ensure that all stakeholders prosper together.

Despite these proclamations, a widespread challenge for leaders to incorporate ESG factors into corporate strategy has been the lack of a transparent, comparable framework for measuring and reporting sustainable value creation for all stakeholders. In response to this challenge, the World Economic Forum’s business community, represented by the International Business Council, acknowledged this problem and launched an international initiative for collective action to identify a core set of ESG metrics and disclosures that could be reflected in annual reports of companies on a consistent basis across industry sectors and countries. At the 2020 Annual Meeting in Davos, the World Economic Forum released a consultation paper titled *Toward Common Metrics and Consistent Reporting of Sustainable Value Creation*. The paper, developed in collaboration with Deloitte, EY, KPMG, and PwC, proposes to establish common metrics for consistent reporting and tracking progress in sustainable value creation resulting from investments in ESG initiatives. Suggested metrics include disclosure related to gender equality, compensation practices, and supply chain management. The adoption of an acceptable framework supporting a consistent set of metrics for tracking progress should catapult stakeholder capitalism beyond an investment-driven thesis into a permanent part of the modern corporate ethos.

While insurance leaders have joined the narrative and many are vocal advocates of stakeholder capitalism, insurance is a natural fit for this new approach to sustainable value creation. The insurance business is rooted in the societal construct that risk should be mutualized. In this way, the insurance industry is well positioned to implement an ESG framework for stakeholder capitalism because it is embedded in the very fundamentals of their business.

The Business Case: Today, companies who have placed ESG factors central to their strategy and operations range from small start-ups to mega global conglomerates across all industries. The one thing all of these enterprises have in common is a clear understanding of what they stand for and a willingness to define their mission beyond the tangible or competitive nature of their products or services. These firms recognize that a well-executed commitment to betterment of our environment, society and governance will lead to superior near-term revenue and long-term value creation.

But how exactly does a strong ESG proposition make financial sense? Research and experiential evidence are clear that firms with a strong ESG mindset adhere to the conditions which drive productivity, creativity, and courage; all of which are directly linked to higher profitability. The conditions include intrinsic motivation of employees, trust, and dense social relationships. As a corollary, research is also clear that the lack of focus on ESG factors generate liabilities. For example, the environmental degradation or lack of inclusivity carries consequences such as reputational damage resulting in the inability to attract talent necessary for delivering top quartile financial results.

However, we know from research that customers today demand more than being sold a product. Good service is the floor for the modern consumer who also evaluates a company based on where it stands on matters of principle, such as the environment, social justice, and inclusive corporate governance. Through stakeholder alignment, insurance companies can earn customer loyalty that has the added benefit of helping control the frictional costs associated with contracting under uncertainty (e.g. moral hazard, fraud).

In addition to improving employee productivity and increasing top line growth through building brand loyalty with customers, a credible focus on ESG factors can actually reduce direct costs, minimize regulatory and legal interventions, and optimize capital allocation. For example, a company's direct costs can be reduced through lower energy consumption, reduced water intake, and decrease waste. By stepping back and framing products and services in terms of how they deliver solutions to environmental and societal problems, firms can gain access to government subsidies and engage regulators in a more constructive dialogue. Lastly, by fully recognizing the opportunity costs associated with the consequences of not doing business under ESG principles, firms will more efficiently allocate capital and avoid investments that will not pay off in the longer-term.

Looking Back to Look Forward: This brings us back to Friedman's doctrine. Freidman's conclusion that the singular purpose of business is to maximize shareholder wealth is dependent on the validity of two critical assumption. First, he theorized that markets are free and equally available to all. Second, he assumed that price reflects all costs. In free markets, prices for goods and services are set by supply and demand without intervention by regulation. With regard to his second assumption, a company engaging in such activities as environmental degradation or who lack diversity and inclusion would, in fact, have a higher cost of capital than companies committed to ESG; and this higher cost of capital would be priced. Markets are not free nor clairvoyant in pricing the risks associated with ignoring ESG factors. The limitation of Friedman's assumptions helps us understand the misconception resulting from his conclusion and why ESG factors are critical in the 21st century economy. Perhaps in time widespread adoption of clear, consistent metrics for tracking and reporting ESG factors may enable markets to explicitly assign a lower cost of capital to firms who effectively manage ESG risk. Until then, markets remain incomplete. Nevertheless leaders who willingly embed an ESG mindset in their operations will enjoy financial benefits by improving employee productivity, increasing top line growth, reducing direct costs, minimizing regulatory and legal interventions, and optimizing capital expenditures resulting in sustainable value creation.

As the case for a strong ESG ethos becomes more compelling there will be widespread adoption in the business of insurance. The adoption must be authentic, credible and deeply embedded in how the company and its leaders act. Products will be repositioned in terms of the role they serve in resolving environmental or societal problems. Business relationships will be established in terms of shared value creation. The industry will develop a labyrinth of public-private partnerships positioning insurance as a part of a broader solution to complex ESG issues. As with all risk, proactive management is superior to reactive management. The cliché that "An ounce of prevention is worth a pound of cure." is actually quite apropos. Leaders committed to embedding an ESG agenda in their core operations, and who recognize how their actions can manifest in measurable financial results, will unlock tomorrow's opportunity. ***Perhaps the purpose of business is purpose***.

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Joan is the founder and former CEO, Blue Marble Micro, Ltd. She is currently serving the industry as an Independent Director for Equitable Holdings, Inc., Ambac Financial Group, Hamilton Insurance Group, Ltd. and The Institutes. She is dedicated to furthering her work in insurance by helping entrepreneurs and leaders align their commitment to Stakeholder Capitalism with drivers of financial success. Joan held a Professorship and Chair at Villanova University and Wharton, University of Pennsylvania.