

Beyond The Facade

Corporate Social Responsibility Reporting: A Potemkin Village?

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FROM THE
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About Saturna Capital

Saturna Capital, manager of the Amana, Saturna Sustainable, Sextant, and Idaho Tax-Exempt Funds, uses years of investment experience to aid investors in navigating today's volatile markets. Founded in 1989 by professionals with extensive experience, Saturna has helped individuals and institutions build wealth, earn income, and preserve capital.

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Amana Mutual Funds Trust



IDAHO TAX-EXEMPT FUND

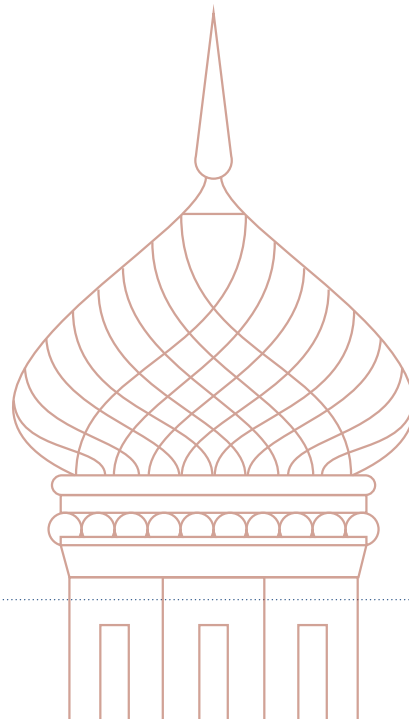


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Executive Summary

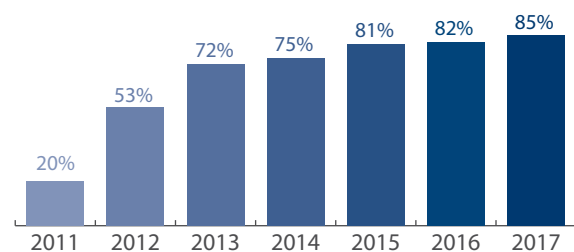
- The number of Corporate Social Responsibility Reports published by S&P 500 Companies has grown from just 20% in 2011 to 85% in 2017.
- Though the rise in data is a positive step toward greater transparency, there is little in the way of assurances that investors are getting the information they need to make truly informed investment decisions.
- Litigation trends in the banking industry provide an example of material information that should be available to investors but is not typically covered in a CSR report.
- Sustainability ratings can be helpful indicators of a company's performance, but ratings providers employ different methodologies that lead to material disparities in outcomes.
- High quality CSR reports will include specific, quantified measures of performance and will make a point of reporting progress toward specific, quantified goals.
- Investors should familiarize themselves with the material ESG issues that apply to each industry in order to make the best informed investment decisions.



As more asset managers begin to integrate environmental, social, and governance (ESG) criteria into their investment strategies, the need for data and disclosures not typically found in traditional financial reporting has increased. Although Corporate Social Responsibility (CSR) disclosures were somewhat rare until recently, investors are coming around to the belief that analysis of a company's ESG risks is just as important as understanding a company's financials. Greater transparency into nonfinancial, material risks has tremendous value for both consumers and investors, but the value of the information that gets reported can occasionally be suspect.

In order to meet consumer and investment demand for this type of data, issuers tend to respond with Corporate Social Responsibility (CSR) reports, alternatively called sustainability reports. The Global Reporting Initiative (GRI), an international standards organization that has developed one of the most comprehensive frameworks for CSR and sustainability reporting, defines the spirit of a CSR report as "a report published by an issuer about the economic, environmental and social impacts caused by its everyday activities." They go on to suggest that such reports should include an organization's values, governance policies, and demonstrate its commitment to a sustainable global economy. The Sustainability Accounting Standards Board (SASB) has also created a framework – the Materiality Map – to help investors and institutions identify industry specific concerns that should potentially be addressed in a CSR report. Though CSR reporting in the US is voluntary, it is mandatory in the European Union for companies with greater than 500 employees.¹ The SEC has explored how to improve reporting and disclosure by soliciting public comments about sustainability disclosures, but also announced in October 2017 that the comprehensive package of proposed changes to corporate disclosures and reporting did *not* include ESG disclosures.² Regardless, 85% of companies in the S&P 500 issued CSR Reports in 2017, up from just 20% in 2011.³

S&P 500 Companies Publishing CSR Reports



Source: Governance & Accountability Institute, Inc.

Concurrent with the rise of CSR reporting, questions have emerged regarding its true utility; CSR reports may more closely resemble marketing materials than financial statements, and while clear reporting frameworks such as the GRI's exist, much of the data companies provide can be cherry picked. In fact, a 2016 PwC survey revealed that nearly three-quarters of investors are neutral or somewhat dissatisfied with ESG reporting practices.⁴ As Robert Gutsche, Jan-Frederic Schulz, and Michael Gratwohl note in their paper *Firm-value Effects of CSR Disclosure and CSR Performance*, "most CSR disclosures have more than 200 pages and contain information that is connected only loosely to CSR performance." There is currently little in the way of assurances that investors are getting the true information they need to make truly informed investment decisions, and companies may benefit solely from the appearance of CSR activities; as Gutsche, *et al.* note, when it comes to CSR reporting "words currently speak louder than actions."



The Potemkin Village legend dates back to late 18th century Russia. Grigory Potemkin – governor of Southern Russia and Empress Catherine II's lover – was believed to have set up mobile villages along the banks of the Dnieper River to impress Catherine as she traveled to visit Crimea and other lands newly acquired from the Ottoman Empire. Potemkin is supposed to have erected the phony settlements and populated them with men and women dressed as peasants, only to disassemble and move the villages further down the river bank once Catherine's barge had passed. While the historical accuracy of the account is unverified, the myth endures; we now refer to any literal or figurative construction built to deceive others as a Potemkin Village.

CSR Reporting: A Potemkin Village?

Taking a cynical view, it could be argued that some CSR reporting resembles the deceptive construction of a Potemkin Village: playing to the demands of investors without stringent guidelines for reporting creates opportunities for companies to play up any good corporate behavior – regardless of its true impact – while minimizing the bad. Gutsche, *et al.* find that “the mere disclosure of CSR activities may be interpreted as good CSR performance and mislead investors in their judgements of the potential long-term risks of their investments.” Further, “both CSR disclosure and performance affect firm value, but the relative effect of CSR disclosure is larger than the total effect of the individual dimensions of CSR performance.”

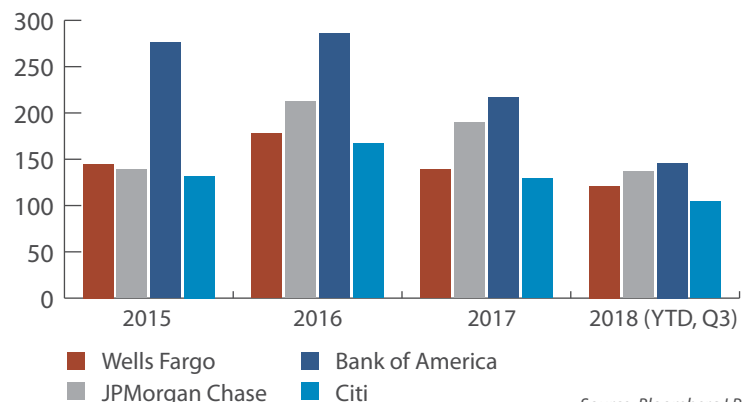
The fact that a company’s reputation may have little to do with true CSR impact is disconcerting. But if not CSR reports and ESG scores, then what should investors be looking at in their investment process?

CSR Reporting in the Banking Industry

One example of a CSR Potemkin Village can be observed within the banking industry. Banking is a complex and largely opaque business, with many of its product lines – such as commercial and consumer lending – employing a “black box” underwriting process. The lack of transparency makes the risk profiles and underlying financial incentives of banking products nearly impossible for most investors to grasp, and we are acutely familiar with how underhanded practices – like stated-income or no-income subprime lending practices – directly led to the global financial crisis. Determining the quality of a bank’s product line and the character of its management team is not an easy task.

There is information available to investors that cannot be manipulated by a bank, however, and that allows an investor to gain true insight into business practices. Litigation trends provide one way to track a bank by business segment or product division over time. The presence of past, ongoing, or pending lawsuits points to risks and future liabilities that

Beyond the Facade: CSR Reporting Omissions Consumer Litigation Claims, 2015 - 2018 (YTD)



may be bubbling underneath the shiny surface a bank's marketing may suggest. Legal costs, whether they are from legitimate or frivolous claims, can also eat up a material segment of a bank's income. Though legal costs among the top 10 US banks have declined by 56% in the past five years, they still represent an estimated \$8.0 billion.⁵ Litigation expenses are far from trivial and they are also highly unlikely to be reported within the pages of a CSR Report.

In 2017, Bank of America (BoFA) was recognized by *Euromoney* as the World's Best Bank for Corporate Social Responsibility.⁶ This was the second time that BoFA earned the award, having received *Euromoney's* inaugural award in 2015.⁷ RobecoSAM, a global trailblazer in sustainable investing, has also lauded BoFA by ranking it Bronze in its 2018 Sustainable Yearbook and thus including BoFA in its select list of 21 high-performing global banks.⁸ Wells Fargo does *not* appear on RobecoSAM's list, which should surprise no one given the scandals that bank has recently faced. What is surprising, however, is that between 2015 and 2018 the number of litigation claims has been meaningfully higher for BoFA than Wells Fargo. Bloomberg data reveals that in 2015, BoFA had 80% more litigation claims filed among its consumer finance group than Wells Fargo. This trend continued through 2018, with BoFA reporting 56% more claims with its consumer finance group than Wells Fargo over the observed period – which seems incredible, considering the fallout of Wells' fraudulent account scandal ultimately resulted in regulatory fines totaling \$185 million.⁹ BoFA's myriad claims are certainly an important and material issue. This litigation history is not disclosed within its CSR reporting, underscoring frustration investors may face in trying to formulate a consistent and integrated ESG investment process.

Small community banks stand in contrast to the behemoth national banks, which tend to receive high ESG scores for disclosure. On the whole, community banks face substantially fewer scandals and lawsuits than their national counterparts, but don't tend to issue glossy CSR reports, either. Thus, community banks do not attract the same meaningful coverage from ESG data providers and rarely receive high scores for disclosure. Though national banks serve a considerably larger customer base and are therefore more exposed to potential claims, it is corporate culture and governance practices – not an outward-facing image – that should be the standard barometers by which a company is measured.

Wells Fargo experienced 1,055 claims in 2017, the highest number of claims filed by customers, investors, and other agents across all of its business segments. When expressed as a percentage of revenues, Wells Fargo's litigation claims-to-revenues ratio was 1.19%, the highest among the small sample of banks. In that same year, BoFA earned a second place ranking as measured in both the number of claims (945) as well as its claims-to-revenues ratio (1.08%). It is interesting to note that TowneBank, a community bank with operations in Virginia and North Carolina, has demonstrated the

DOES A CSR REPORT

GIVE INVESTORS

THE WHOLE PICTURE?

best performance measured both by number of claims (a single instance), as well as a claim-to-revenues ratio of 0.22%.

This presents an interesting angle for investors to consider as they look to CSR reporting and ESG scores in their investment process. It is entirely possible that an underdog with a less integrated CSR program could be the better governed investment. TowneBank appears to demonstrate the desired governance attributes and attention to material risks investors should seek – even in the absence of a flashy CSR report. TowneBank also managed to generate positive and growing earnings during the global financial crisis, a point of pride that few banks in the US can claim.

	3rd Party Sustainability Scores			Total litigation claims 2015 - 2018 ^A	2017 Revenues (USD, Millions)	2017 Claims	2017 Claim-to-revenue ratio
	RobecoSAM	Sustainalytics	Bloomberg Disclosure				
Wells Fargo	31	46	43	3,706	\$88,389	1,055	1.19%
JP Morgan Chase^B	38	76	47	2,671	\$99,624	661	0.66%
Bank of America	84	72	66	3,970	\$87,780	945	1.08%
Citi^C	78	62	54	1,858	\$71,449	438	0.61%
HomeStreet	n/a	n/a	13	8	\$507	3	0.59%
Hanmi Financial	n/a	n/a	15	13	\$210	4	1.90% ^D
TowneBank^E	n/a	n/a	13	4	\$449	1	0.22%

Source: Bloomberg LP

^A Total litigation claims are from 2015 through 2018 (YTD, Q3).

^B JP Morgan comprised 1.5% Sextant Core and 3.29% of Sextant Growth Funds' portfolios as of September 30, 2018.

^C Citi (Citigroup) comprised 0.76% of Sextant Core Fund's portfolio as of September 30, 2018.

^D Hanmi Financial, a large Korean-American community bank, reports a high claim-to-revenue ratio of 1.90%. Three of the litigation claims are associated with patent laws rather than core banking issues, however; looking at the claim-to-revenue ratio without these three claims would put the ratio at 0.48%.

^E TowneBank comprised 1.94% of Saturna Sustainable Fund's portfolio as of September 30, 2018.

Looking to reputable and independent ESG analytics firms, such as Sustainalytics or MSCI, to offer outside guidance presents its own challenges. Each firm employs a different methodology leading to material disparities in outcomes – and the methodologies may differ from an investor's preferences. CSRHub, a data provider for the sustainability industry, found that the correlation between MSCI's and Sustainalytics' ratings was only 0.32. By way of contrast, credit ratings assigned by Standard & Poor's and Moody's Investors Service were closely aligned with a correlation of 0.90.¹¹ Such a low correlation raises questions about the efficacy and effectiveness of sustainability related reporting.

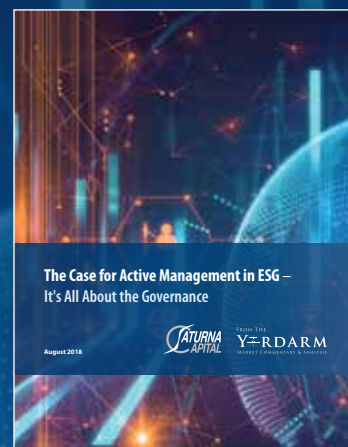
CSR Reporting: Best Practices

Litigation, in the case of banking, is an example of a material issue that provides meaningful insight to investors, while a bank's management of water and wastewater is, perhaps, of less concern. For a company that engages in the water-intensive manufacture of semiconductors, however, the relative importance of litigation claims versus wastewater management might be reversed. Credible CSR reports distinguish themselves by incorporating a materiality matrix alongside details of their outreach to stakeholders. High-quality CSR reports will also include specific, quantified measures of their performance across a variety of environmental, social, and governance issues and will make a point of reporting their performance against a set of specific, quantified goals.

As we saw with TowneBank, some of the best actors in a given industry may not have formal CSR reporting practices but typically shine through on the basis of good governance, broad stakeholder engagement, and favorable financial and investment performance. Investors are also wise to consider issuers who report honestly when they fail to meet their targets. Transparency in this way – paired with a diligence to redouble on improvement efforts – indicates a level of sincerity that photos of Corporate Volunteer Day do not. Investors can use third party sources, such as the Sustainable Accounting Standards Board's Materiality Map, to familiarize themselves with issues a company should be tracking and reporting, but it is ultimately clear targets, consistent data, and demonstrable progress that are key to cutting through the noise. 🦋

What About Those Ratings?

In the quest to find top-tier firms that seek to reduce risk through industry best practices, we find that a passive approach to ESG investing exposes investors to risk from subjectivity and bias inherent in quantitative scoring systems. For example, no scoring system will be able to determine that a company's board of directors is made up of the CEO's golfing buddies. For more information and insights into the world of sustainability ratings, see our August 2018 edition of **From The Yardarm: The Case for Active Management in ESG**.



About The Authors



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Senior Investment Analyst and Portfolio Manager

Patrick T. Drum, Research Analyst and Portfolio Manager, joined Saturna Capital in October 2014.

He is a former adjunct professor of finance for the Sustainable MBA Program at the Bainbridge Graduate Institute (BGI) currently known as Presidio Graduate School. Mr. Drum holds a BA in economics from Western Washington University and an MBA from Seattle University Albers School of Business. He is a Chartered Financial Analyst Charterholder and a Certified Financial Planner®.

Prior to joining Saturna Capital, Mr. Drum led environmental, social, and governance (ESG) research and was director of fixed income portfolio management since 2007 with a private account group at UBS Institutional Consulting Services specializing in investment management for global conservation and national wildlife park endowments as well as sustainable-social screened client portfolios. He is a former Chair of the United Nation's Principles for Investment (UNPRI) Fixed Income Outreach Subcommittee and a current member of the UNPRI's Bondholder Engagement Working Group (BEWG), an advisory committee working to elevate important ESG considerations and best practices among issuers and investors.

Mr. Drum's past experience also includes business valuation at Moss Adams and portfolio management at Washington Mutual Bank. Mr. Drum is a member of the board of trustees to the Museum of Glass in Tacoma and a member of Rotary.



Stephanie Ashton

Manager of Corporate Social Responsibility

Stephanie Ashton joined Saturna Capital in 2012. As Manager of Corporate Social Responsibility she develops Saturna's internal sustainability initiatives, manages sustainability reporting, and contributes to overall sustainability strategy.

Ms. Ashton graduated from Western Washington University in 2006, majoring in English (Creative Writing emphasis) and minoring in French. Her professional background includes eight years in legal support as well as non-profit experience. She is passionate about a number of sustainability issues – notably sustainable agriculture and local food – and currently serves on the Board of Directors for the Bellingham Food Bank.

Footnotes

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