

ICGN Viewpoint

Coronavirus as a new systemic risk: implications for corporate governance and investor stewardship

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The Coronavirus, now commonly known as COVID-19, emerged in December 2019 and has quickly become a global crisis that threatens the health of individuals and the welfare of societies on a vast scale, including its impact on global economic activity and growth. The Organisation for Economic Co-operation and Development predicts that global growth could drop to 1.5 per cent in 2020, half the rate projected before the virus outbreak.

The COVID-19 crisis has been well-documented in the media and continues to propagate in many countries around the world, and has been officially confirmed as a pandemic¹ by the World Health Organisation (WHO). At its core COVID-19 is a humanitarian crisis, placing the welfare of people and health systems at great risk. As of the time of writing 124 countries have been affected with collectively 127,000 cases and around 4,700 deaths – the figures change extensively on a daily basis. It is difficult, if not impossible, to assess at this point its longevity, trajectory or the full social and economic consequences. Government policies to address and control COVID-19 should clearly, and rightly, prioritise the protection of human health along with the sustainability of public and private health systems as guiding imperatives.

While government policy responses will be required to address as a matter of urgency the risks to individual and public health, the COVID-19 crisis is also having a real impact on economic activity and financial markets. The ongoing—and profound—uncertainties create great challenges for corporates, their boards and their investors as they contemplate how best to navigate these difficult and dynamic times.

This Viewpoint explores the corporate governance and investor perspectives relating to the COVID-19 crisis. It first identifies COVID-19 as a systemic risk and considers the role of institutional investors and how this crisis links to their own fiduciary duties, investment horizons and stewardship practices. The second part of the Viewpoint provides a corporate

¹ A pandemic is the spread of an infectious disease occurring on a scale which crosses international boundaries regions, usually affecting a large number of people.

governance lens, to focus on board leadership and effectiveness. The Viewpoint concludes with questions that investors may wish to consider in their engagement with company managements and boards related to COVID-19 or crisis management more generally.

COVID-19 as a systemic risk

COVID-19 clearly meets the criteria of a systemic risk as put forward in ICGN's 2018 Guidance on Investor Fiduciary Duties: "The nature of systemic risk is that it builds over time, it is interactive and synergistic and, once in play, is difficult to control. Systemic risk drivers tend to be cumulative and/or interdependent, resulting in far-reaching impacts, shocks or even system-wide failure."²

Addressing systemic risks responsibly is a moral and economic imperative both for investors and companies. Investors may differ among themselves with regard to specific investment strategies, time horizons, or approaches to ethics and social impact in the investment process. However, the urgency of systemic risks can and should transcend many of these potential differences and bring otherwise diffuse and competing investors together to identify solutions and address common problems.

Time frame can be a critical consideration in addressing systemic risks. In the case of COVID-19 there are both near term urgencies and long-term dimensions that must be considered. The near-term priority is to seek to contain COVID-19 as a matter of public health. This will come at a cost, at least in the short-term to economic activity, company performance and profitability. This in turn can depress returns and financial asset values for investors. But there is also an important long-term perspective.

The investor response: keep calm and maintain a long-term perspective

Despite these negative economic events investors should avoid focusing on the crisis in terms of its short-term shareholder value implications. It is here where a long-term perspective, and perhaps a grounding ethics and values more generally, should also guide investor responses. In the language of modern finance, this may be less an opportunity for investors seeking alpha generation in individual companies than it is a question of addressing 'beta' issues—the volatility/stability of the markets and financial system as a whole. This may be fiendishly complicated, but an important guiding principle for investors

² ICGN Guidance on Investor Fiduciary Duties, 2018: http://icgn.flpbks.com/icgn-fiduciary_duties/#p=1

relates to their fundamental fiduciary duty of care to their beneficiaries. This confirms the importance of taking a long-term perspective, since most ICGN Members, and large institutional investors more generally, are managing assets for pension plans or retirement saving plans, where the investment horizon is intrinsically long-term, or in theory infinite.

It is beyond the scope of this Viewpoint to suggest specific investment or trading strategies for investors in addressing the impacts of COVID-19. There is no generic solution. These will differ depending on individual investor mandates and beneficiary requirements. But from the perspective of investor stewardship and fiduciary duty -- and consistent with ICGN's Global Stewardship Principles and Policy Priorities³-- it is fair to suggest that in reacting to this crisis investors should generally seek to maintain an approach that promotes long-term investment horizons and sustainable value creation for individual companies and markets.

As a practical matter this requires investors to appreciate that companies will be facing difficult questions in response to the impacts of COVID-19. The first priority for managers and boards will be to ensure the company's own financial sustainability. Investors must also understand that capital allocation questions may surface where compromise is required. Companies may have to choose between cutting dividend payments, cutting capital spending or cutting costs, possibly leading to redundancies. Investors should demonstrate support for companies as they navigate potentially acute financial threats and market pressures. Investors should also avoid encouraging companies to undertake undue risks that might provide a short-term investor benefit but could also jeopardise a company's financial stability or the sustainability of its business model. This reflects not only some level of enlightened self-interest, but also the moral imperative to contribute positively to the broader threats to public health and social stability.

The company response: board effectiveness and acting strategically

Until recently, COVID-19 would have been for most companies and boards a proverbial "unknown unknown". However, many companies will have had in place disaster or crisis planning capabilities to deal with these sorts of unknowns or unanticipated shocks. In the first instance this often comes under a company's risk management function and then through risk oversight of management's response to such risks at the board level. Some boards (including ICGN itself) may have existing risk or crisis committees to help define decision-making or operational protocols. The crisis committee often works closely with

³ One of ICGN's five policy priorities is to promote long-term investment perspectives for sustainable value creation. See ICGN Policy Priorities 2019/20: <https://www.icgn.org/sites/default/files/ICGN%20Policy%20Priorities%202019-20.pdf>

management and takes a lead in addressing unexpected emergencies. This can be an important contributor to board effectiveness. However, the urgency of COVID-19 means that this is a matter for the board as a whole, and that the board is ultimately accountable for a company's responses, even though the company's management itself may be confronting these risks on a day to day basis.

Prioritising individual and public health

Boards and investors recognise that as a public health crisis the overarching public imperative of governments to COVID-19 will be to prioritise the health of individuals and the health system. In developing their own private sector responses to the crisis boards should respect these public policy priorities and also consider within the company's own sphere of activity how to show support to individuals or businesses that have been disrupted economically by COVID-19. Global resources including the World Health Organization⁴ (WHO) and the US Center for Disease Control (CDC)⁵ can provide critical guidance for both public sector policy makers and private sector responses.

Developing an informed and strategic response

Investors will expect corporate boards to address the potential business impact of COVID-19 and to develop an appropriate strategic response. In a recent Financial Times piece, the economist Mohamed El-Erian makes the positive point that the financial system, at least so far, is not threatened as it was in 2008 recent financial crisis. But he also notes that there is scope for continued economic decline and that we do not know yet what the bottom will be.⁶ Given these ongoing uncertainties, a recent McKinsey briefing note frames this as a situation calling for a scenario planning approach, and suggests three fundamental planning scenarios, labelled as: "quick recovery", "global slowdown" and "global pandemic and recession".⁷ Scenario planning is important for both governments and companies, but it remains far from clear which of these scenarios, if any, will prevail. In any event the

⁴ World Health Organization, COVID-19 Situation Report 50, 10 March 2020: https://www.who.int/docs/default-source/coronaviruse/situation-reports/20200310-sitrep-50-covid-19.pdf?sfvrsn=55e904fb_2

⁵ The Centers for Disease Control and Prevention, 26 February 2020: https://www.cdc.gov/coronavirus/2019-ncov/community/guidance-business-response.html?CDC_AA_refVal=https%3A%2F%2Fwww.cdc.gov%2Fcoronavirus%2F2019-ncov%2Fspecific-groups%2Fguidance-business-response.html

⁶ Mohamed El-Erian, How this Crisis is different from 2008—and the same, Financial Times, 9 March 2020: <https://www.ft.com/content/c789f080-6203-11ea-a6cd-df28cc3c6a68>

⁷ McKinsey and Company, COVID-19: Briefing note, March 9, 2020: <https://www.mckinsey.com/~/media/McKinsey/Business%20Functions/Risk/Our%20Insights/COVID%2019%20Implications%20for%20business/COVID%2019%20March%2009/COVID-19-Briefing-note-March-9-2020-vF.ashx>

disruption and negative impacts have already proven to be huge for companies and for those in company supply chains.

There are a number of ways that companies and boards can approach these issues. McKinsey suggests a model bringing together executive leadership and epidemiological subject matter expertise together with planners and project coordinators as a 'nerve center' to provide central coordination and a support to relevant groups including employees, customers, the supply chain. It also identifies financial stress testing by management as a formal response.⁸ The US law firm Alston & Bird also focuses on strategic board oversight, including risk heat mapping, business interruption or contingency plans and supply chain oversight. It notes that boards will need to monitor developments dynamically and be prepared to meet and act at short notice.⁹ The US-based National Association of Corporate Directors has similarly prepared for its members a short checklist to assess management readiness to deal with COVID-19, focusing on threat detection and response.¹⁰ ICGN's own guidance on corporate risk oversight presents a comprehensive general framework relating to board oversight of risk management, including how boards dialogue with investors on risk management.¹¹

Questions for investors engaging with companies

1. Does the board recognise its role and accountability to provide oversight to the company's management of the COVID-19 crisis?
2. How is the board structured to address the crisis? Is there a clarity of roles and responsibilities?
3. How does the board get information about the crisis and demonstrate that it has an adequate and up-to-date understanding of the risk faced by the organisation?
4. Does the board have access to internal or external subject matter experts on COVID-19 to support decision making?

⁸ McKinsey and Company: Coronavirus COVID-19: Facts and Insights, 9 March 2020: <https://www.mckinsey.com/~media/McKinsey/Business%20Functions/Risk/Our%20Insights/COVID%2019%20Implications%20for%20business/COVID%2019%20March%209/COVID-19-Facts-and-Insights-March-9-final.ashx>

⁹ Dave Brown and Luke Trompeter, Alston & Bird COVID-19 Task Force, "Managing Strategic Risks in the Face of the Coronavirus", Directors and Boards.com, 5 March 2020: <https://www.directorsandboards.com/news/managing-strategic-risks-face-coronavirus>

¹⁰ National Association of Corporate Directors, Assessing Management's Readiness to respond to the COVID-19 Crisis: A Quick Checklist for Boards, 2 March 2020: <https://www.nacdonline.org/insights/publications.cfm?ItemNumber=67340>

¹¹ See ICGN Guidance on Corporate Risk Oversight, 2015: http://icgn.flpbks.com/icgn_corp_risk_oversight/#p=1

5. If a crisis management committee exists how does the board allocate responsibilities to it and how does this committee interact with management and the board as a whole?
6. Scoping the problem: what are the key financial risks and pressures and how resilient is the company to confront negative economic outcomes?
7. How is the board addressing the crisis and its impact on employees, customers, supply chains and local communities?
8. What key financial and strategic decisions have to be made and in what time frame?
9. How will the company balance the interests of shareholders, stakeholders and the overall sustainability of the company itself?
10. What are the plans for business continuity?
11. How are communications managed internally and externally?
12. How will the company communicate the economic impacts and threats to the company's financial sustainability and business model?

About ICGN Viewpoints

While not defining a formal ICGN position on the subject, ICGN Viewpoints provide opinion on emerging corporate governance issues and are intended to inform and generate debate.

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