

ESG Spotlight

The Brexit: Assessing the ESG implications

24 June 2016

Themes:

ESG regulation

Sectors:

All

Country:

UK

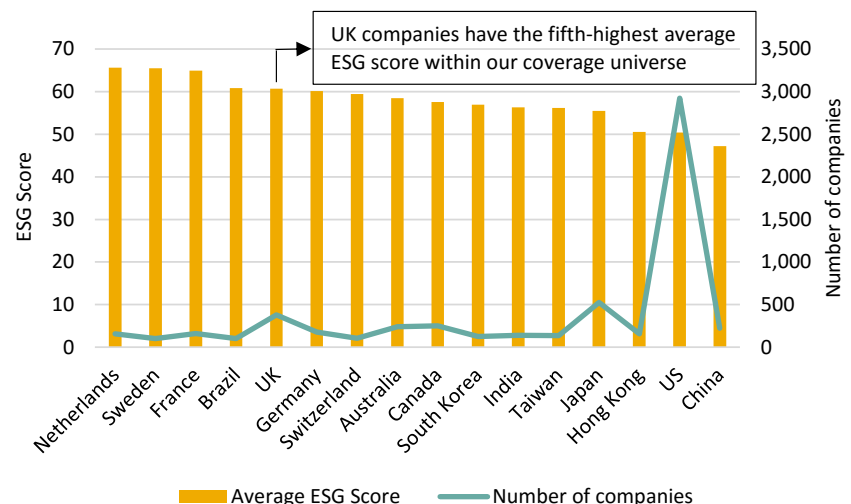
Key Insights

- On seven of nine examined ESG issues, we judge **the probability of a policy change in a post-Brexit UK to be low or moderate** over the short run, which should support the continuity of UK firms' strong ESG performance.
- On two issues, recycling and air pollution, the UK's withdrawal from the EU could lead to a **weakening of domestic standards**, which could blunt UK firms' incentives to develop programmes in these areas.
- Though the UK has a tradition of strong corporate governance, the UK government's **resistance to the EU ESG Disclosure Directive** could be a concern for investors as the UK negotiates its withdrawal from the EU.

Taking stock of regulations

What are the implications of yesterday's historic plebiscite for the development of ESG policy in the UK? And could a change in policy direction affect the ESG performance of UK firms? As shown in the chart below, UK companies represent some of the world's top ESG performers, and their strong ESG pedigree is due in no small part to the progressive policy environment in Brussels and London. While it is far too early to offer definitive conclusions, as nobody can say with certainty how the regulatory priorities of an independent UK will evolve, our analysis suggests that the Brexit is unlikely to trigger a change in policy direction in the UK on seven of the nine ESG issues we examined. This in turn supports our view that the UK's withdrawal from the EU is unlikely to significantly alter the ESG profile of UK firms.

Average ESG score by country*



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* Among countries with 100 or more companies in our coverage universe

Source: Sustainalytics

The Brexit – What's next?

Assessing a change in policy direction on nine ESG issues

For most ESG issues, we do not anticipate a change in policy direction over the short run

One of our clients' foremost concerns is the extent to which the Brexit could negatively impact the ESG performance of UK firms. As a starting point to determine the possible ESG knock-on effects, we have examined nine key ESG issues and assessed the likelihood of a change in policy direction in a post-Brexit UK. While uncertainties will continue to linger for quite some time, particularly as the UK has two years to negotiate the terms of its exit from the EU, this analysis provides a foundation to speculate on where UK firms may trend on specific ESG topics.

The results of our analysis are summarized in the table below. For seven of the nine ESG issues we examined, including climate change, human capital and executive remuneration, we judge the probability of a policy change to be low or moderate. In many cases, this is because the relevant norms or EU directives have been enshrined in foundational UK laws that will be difficult for the UK government to overturn. These include such laws as the Climate Change Act (2008) and the Health and Safety at Work Act (1974). In other cases, domestic UK standards exceed what is (or was) required under EU Directives, as with product quality standards, executive remuneration and the Corporate Governance Code.

However, on two issues, recycling and air pollution, there is reason to believe that the Brexit could lead to a weakening of domestic standards, which could blunt the incentive for UK firms to develop programmes in these areas.

Probability of policy change in the UK for selected ESG issues

Theme	ESG Issue	Probability of change	Summary of implications
Environment	Climate change	Moderate	The UK has signalled the possibility of change by slashing solar subsidies, but the Climate Change Act (2008) is likely to continue to serve as a clear policy signal for corporate GHG reduction programmes.
	Recycling	Likely	The UK has expressed concern about EU policy direction in this area, and there are indications that the Brexit could lead to a downgrade in UK recycling policy, targets and/or enforcement.
	Air pollution	Likely	The UK has struggled to comply with EU rules on air quality and is currently subject to EU infraction proceedings. The Brexit could lead the UK to repeal existing legislation, potentially weakening domestic emissions standards.
Social	Human capital	Moderate	Most employee protections are enshrined in UK law, and UK standards in some areas, such as shared parental leave, exceed EU requirements. However, employers may gain more discretion in some areas.
	Product quality standards	Low	While the UK will not have a seat at the EU table, product quality standards are unlikely to be weakened given the importance of the EU export market.
	Health and safety	Low	Most health and safety requirements stem from the UK's Health and Safety at Work Act (1974) and are unlikely to be affected by the Brexit. Workplace fatalities have fallen in the UK since the mid 1990s.
Governance	Corporate governance	Moderate	The UK has some of the strongest standards globally on boardroom practice, though it resisted some aspects of the EU's ESG Disclosure Directive
	Executive remuneration	Moderate	The UK has resisted the EU's bonus caps for financial firms, but in other respects we do not expect significant regulatory downgrades on executive remuneration.
	Intellectual property	Moderate	It is uncertain whether the UK will elect to participate in the newly proposed pan-European patent legislation or to implement its own replacement law.

Source: Sustainalytics

Taking a closer look

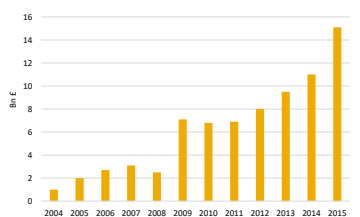
Below we explore the implications of the Brexit for nine key ESG issues, segmented by theme (Environment, Social and Governance). We have focused on identifying areas of possible policy divergence between the UK and EU.

Environment

Climate change

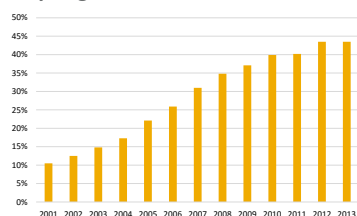
We do not anticipate a sudden reversal in the UK's climate change strategy, or in the GHG performance of UK firms, although there are indications that the UK might diverge from the EU in some areas. UK companies will continue to be affected by the UK's Climate Change Act (2008), which sets a domestic target to reduce GHGs by 80% below 1990 levels by 2050. The UK is also an independent signatory to the Paris Agreement and will have the opportunity to ratify the treaty. While the UK will not be obliged to meet the EU Renewable Energy Directive, most of the renewable energy projects that the UK initiated to comply with this legislation are either underway or in the approval phase. However, the UK was on a pathway towards slashing solar subsidies before the Brexit, and any sustained negative financial effects from the transition could result in a weakening of domestic renewable energy policies and incentives. Though 2015 was a record year for UK investment in renewables, as shown in the chart to the left, investment could fall in the coming years, with the rollback of subsidies.

UK Clean Energy Investment



Source: Sustainalytics, based on BNEF

Recycling Rates in the UK



Source: Sustainalytics, based on DEFRA

The UK is currently subject to EU infraction proceedings covering ambient air pollution

Recycling

The UK would not be required to comply with the European Commission's Circular Economy Package, a group of proposals that set ambitious targets in the areas of municipal waste and packaged waste recycling. The Cameron government has expressed concern over the proposed targets, which include a provision requiring 75% of packaging waste to be recycled by 2030, and some large recycling companies, including Suez, expect the Brexit will stall UK recycling policy. Household recycling rates in the UK, though rising steadily from 2000–2010, have levelled off since, and the UK's recycling rate lags behind half a dozen EU countries. While we would not expect to see large UK corporates with advanced recycling programmes abandon their current initiatives, a slowdown in the rollout of national recycling policies (and, perhaps more importantly, the *enforcement* of policies) could have negative knock-on effects for corporate recycling programmes, particularly for smaller organizations.

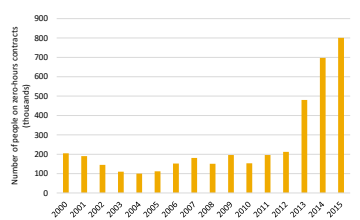
Air pollution

The UK has struggled to comply with the EU's Ambient Air Quality Directive, which sets limits on the level of sulphur dioxide, nitrogen dioxide and oxides of nitrogen, particulate matter and lead for EU members. The UK failed to develop a plan to reach nitrogen dioxide limits by 2015 in line with EU requirements, and is currently subject to EU infraction proceedings. While the directive has been enshrined in UK law, the Brexit could allow the UK to repeal existing legislation and relax air quality standards.

Social

Human capital

Zero-hours contracts in the UK



Source: Sustainalytics, based on UK ONS

Most employee protections are enshrined in UK law and are unlikely to be repealed as a result of the Brexit. These include rules preventing discrimination based on age, race, sexual orientation or gender, as well as unfair dismissal and minimum wage protections. On some issues, such as shared parental leave, UK law goes beyond what is required by EU directives. However, in grey areas of employment law, including paid holidays, minimum rest periods and the ability to carry forward holiday time, employers may have greater discretion in a post-Brexit environment. The sharp increase in zero-hour contracts (see chart at left) has been a concern in the UK, as they offer limited employee protections, and the Brexit is not likely to move in the direction of prohibiting such contracts. Of further significance to companies are the implications of the Brexit on talent retention and the freedom of movement for EU employees. New restrictions on residency, for example, could hamstring UK companies that rely on EU employees, whether for highly specialized positions or as general labour needs.

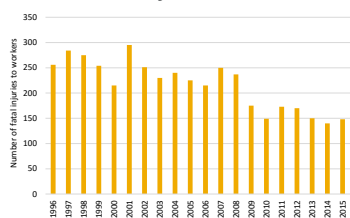
Product quality standards

UK exporters will need to meet EU product quality standards

The UK will not have a seat at the table to determine future changes to EU product quality standards, which currently include the Old Approach and New Approach Directives, as well as the General Product Safety Directive (GPSD), among others. Nonetheless, the UK will be required to meet (or exceed) these standards in order to export products, ranging from food and beverages, to toys, to machines or medical devices, to EU markets. On the food labelling side, the Soil Association, the UK's most important organic certification organization, claims that its standards on animal welfare, environmental and wildlife protection are stricter than existing EU standards.

Health & safety

Number of fatal injuries to UK workers



Source: Sustainalytics, based on UK HSE

It is doubtful that the Brexit will weaken the UK's health and safety regime. Most health & safety requirements imposed on UK companies stem from the UK's Health and Safety at Work Act (1974) rather than EU legislation, and these requirements will survive the Brexit. Moreover, some UK health & safety laws, such as those relating to asbestos treatment, are stricter than what is required by EU legislation. Additionally, the UK Sentencing Council has issued tough new guidelines for health and safety violations that are scheduled to come into force in Feb 2017, resulting in some of the toughest allowable penalties globally. As shown in the chart to the left, the absolute number of fatal workplace injuries in the UK has declined significantly since the mid-1990s.

Governance

Corporate governance

The UK is widely recognized as a corporate governance leader

The UK has a long-standing track record as a Corporate Governance leader since 1992 and has some of the strongest standards globally on boardroom practice. These standards, embodied in the Companies Act and Corporate Governance Code, are supported by well-respected domestic oversight institutions such as the Financial Reporting Council, the Bank of England, and the London Stock Exchange. The UK, which adopts a principles-based approach as well as requiring directors to "comply or explain"

to shareholders when deviating from the Code, has influenced, informed and cooperated with the EU's corporate governance practices. Though the UK was the first country to mandate company disclosure on GHG emissions, it has opposed some provisions of the recent EU's ESG Disclosure Directive, due to come into force in December 2016. According to CSR Rapporteur Richard Howitt, David Cameron insisted that the Directive apply only to listed companies, which reduced the number of EU companies affected by the increased ESG reporting requirements from 18,000 to approximately 7,000.

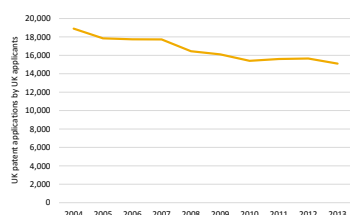
Executive remuneration

The UK is likely to retain potent tools against excessive executive remuneration

The UK has resisted the EU bonus cap rules for financial firms, which it has refused to extend to smaller firms since 2014. The UK has “explained” to the EU that the rules would have disproportionate effects on small firms, and that the bonus caps have raised fixed pay, eliminating any minimizing effects on total compensation. (The UK is not a standout for its resistance to bonus caps, however, as several EU nations, including France, the Netherlands, Ireland and Luxembourg, have also resisted this regulation.) The Brexit may let the UK escape banking remuneration regulations from the European Banking authority that it has opposed or resisted. However, the UK has and is likely to retain potent tools against excessive compensation, such as binding shareholder votes on pay policy and a long-standing advisory vote on pay, under which shareholders have already protested this year at a number of high-profile companies.

Intellectual property

UK patent applications by UK applicants



Source: Sustainalytics, based on UK IPO

The Brexit may delay or complicate the introduction of the EU's proposed unitary patent and unified patent court legislation, which is supposed to come into force in early 2017. The UK could elect for continued participation in the European patent system, but could also elect to implement its own replacement law. Though it is likely that a UK patent law would align broadly with the EU's proposed patent laws, UK firms with existing pan-European patent rights could need to reapply for new rights under a new UK law and incur the costs of re-applications, particularly since amendments to the 2004 Patent Act enabled UK companies to file patents in the EU, while skipping filing at home. (Notably, year-on-year patent applications filed in the UK by UK residents have declined steadily from 2004–2013.) UK businesses may need to undertake a thorough review of their current IP protections to see if they will hold up post-Brexit. IP-heavy sectors such as Pharma and Software may be particularly affected.

Conclusion

Our assessment of the Brexit's ESG implications suggests that media reports both for and against may have exaggerated the impacts of the Brexit on UK companies. However, this is not to say that the ESG pathway ahead for Britain will be altogether smooth. Though we expect in most cases that regulations affecting ESG issues will remain largely on track, if the UK experiences financial difficulties, as well as further populist upheavals, both enforcement of regulations, particularly environmental ones, and government investment in ESG-related programmes and technologies may suffer in the longer term.

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