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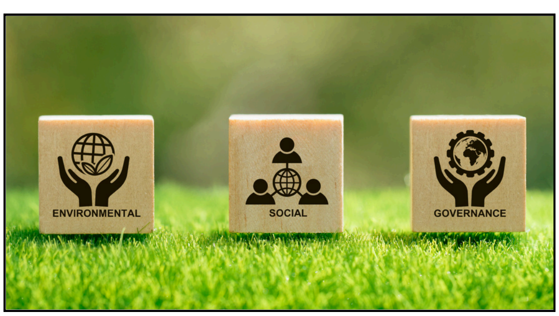
IT'S THE GOVERNANCE, STUPID

WHY "E" ISN'T THE WHOLE STORY

I'm often asked to rank the three aspects of ESG. Most people assume I'll say "E," given my academic background in environmental science and my years working at Vancity Investment Management, a subsidiary of Vancity Credit Union, which is known for its focus on climate action.

But as I'm sure you've guessed from the title, this is not the case. In fact, it was looking for the underlying causes of environmental issues that led me to conclude that governance is key.

Workers stuck in low-paying jobs aren't focused on the environmental risks of a factory promising high wages. Corporate managers and investors don't plot to pollute rivers when allocating capital. Most people simply respond to the incentives in front of them. Without strong governance to guide information and process, those decisions often miss the bigger picture.



This highlights two key points that underpin decisions and outcomes related to environmental and social matters.

First, the majority of people will not care about the environment when they are struggling to keep a roof over their family's head and put food on the table.

Second, the majority of corporate managers and investors think they are taking environmental and social factors into account but often don't realize they lack the information and analysis needed to incorporate them effectively. Or else they reduce governance to a compliance exercise rather than a discipline integral to making better long-term decisions.

PROCESS VERSUS OUTCOME

Governance is fundamentally about how decisions are made - think process

Environmental and Social are about what and who those decisions affect - think outcome

Governance is the discipline that makes environmental and social performance possible

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ESG ORIGINS

ESG was coined in 2004 amid scandals such as Enron and WorldCom, when corporate governance was under intense scrutiny.

It was in this context that Corporate Social Responsibility (CSR) evolved into ESG. In this transition, governance shifted from the system enabling "E" and "S" to just another equal pillar.

Its importance was acknowledged, but its true function was diluted in the process.

GOVERNANCE AS THE FOUNDATION

Without good governance – the true foundation – lasting solutions to social or environmental issues will elude us. That's why I argue it should be GSE, not ESG – governance first, because without it, E and S cannot stand.

And this isn't theoretical, it plays out daily in ESG practice. Much of what is broken in ESG – see last week's article – stems from an overemphasis on the environment because it's easiest to quantify, package into a report and declare complete.

Social factors, by contrast, are harder to quantify, so they are too often reduced to slogans and PR campaigns instead of being managed as core human capital issues. And then the only thing that could help, governance, is too often treated as a checkbox exercise to justify decisions rather than a discipline to improve them.

Focusing on governance is key to fixing ESG. Over recent decades, oversight structures have existed on paper, but accountability has grown symbolic. Too many procedures and safeguards meant to ensure resilience persist only as formalities rather than effective checks. Corporate governance failures mirror broader governance trends across Western democracies.

The slogan "It's the Economy, Stupid" was right for its time. In the early 1990s, the economy was the neglected foundation issue and naming it helped refocus political debate. Today, governance has slipped into that same neglected position. We've allowed the governance systems that make economic, social, and environmental progress sustainable to erode.

When governance works, it fades into the background but when it fails, its abstract nature makes the breakdown harder to see. Governance documents and process checklists don't vanish when governance fails, they persist. But only as routines observed in form, not in substance. Much like national elections in a dictatorship, they continue to exist but serve more as displays of legitimacy than as genuine mechanisms of choice.

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BACK TO BASICS: PUTTING GOVERNANCE FIRST

Fixing ESG requires a laser-like focus on governance and oversight. Not as a rote exercise in adopting policies and procedures, but as a framework for better decisions. How is the governance of investment mandates and business processes helping achieve your firm's goals? Too often this fact is lost amid an ever-expanding list of policies and oversight mechanisms promoted as good governance.

Governance failures are most clearly seen in the interaction between corporations and their shareholders. Companies often fight first, then adopt governance mechanisms advocated by shareholders. But with a compliance mindset, they don't appreciate the spirit of these systems, so they remain more symbolic than substantive.

Most shareholders have good intentions but with geographically diverse portfolios, multiple asset managers, and an expanding breadth of investment risks, they are rarely equipped to evaluate governance effectively across every context. The result is plenty of attention to governance, but much of it is focused on appearance, not substance.

This builds on last week's exploration of ESG's shortcomings. In the weeks ahead, we'll explore how governance, done right, becomes the bedrock of sustainable progress – and how reclaiming it is essential to ESG's future.

WHERE TO START?

Good governance starts with principles. It means understanding the purpose behind decision-making frameworks and the outcomes they're designed to achieve.

Are the right people making the decisions — those with the knowledge, authority, and accountability to act responsibly?

Are there systems to ensure decision-makers have the right information, and that the process is transparent and open to scrutiny?