HYMANS ROBERTSON

Responsible Investment

News and Views

Q4 2024

Artificial intelligence (AI) has been one of the most talked about topics of 2023 and 2024. But as interest has skyrocketed, has the world of responsible investment adequately kept pace with AI's technological developments?

The buzz around AI has been a driving force behind equity markets. While AI has been credited as a driver of returns, relatively little attention seems to have been paid to the associated risks. The increased use of AI has prompted warnings across a broad range of topics, from biased algorithms and disinformation to widespread job losses and broader systemic risks. To date, the effort given to understanding and integrating AI-related ESG risks is still small compared to more established themes like climate change. We highlight some of these risks below.

Environmental impacts

Training AI models takes vast amounts of energy. For instance, GPT-3, with its 175 billion parameters, required 1,287 MWh of electricity, producing 502 tons of CO2.[1] Meanwhile, models continue to grow exponentially in size and energy intensity. Global data centres account for around 2–4% of global emissions,[2] exceeding those of the aviation industry. Although there are increasing efforts to use renewable resources, data centres continue to make use of fossil-fuel energy. In a world needing to decarbonise, AI could exacerbate emissions through increasing energy requirements but it could also drive efficiency improvements or be used as a tool to improve environmental outcomes.

Cybersecurity threats

Because they are easy to use, generative AI technologies can be open to abuse by people seeking to spread misinformation, facilitate cyber-attacks or access sensitive personal data. Malicious actors can manipulate AI tools to clone voices, generate fake identities and create convincing phishing emails, all with the intent to scam, hack, steal a person's identity or compromise their privacy and security. However, while AI can increase the risk to individuals, it can also be utilised to increase security. With the estimated average cost of a single data breach approaching US$5 million, companies need to ensure they are putting in place appropriate protections.

Data privacy issues

AI poses significant risks to data privacy, primarily due to the potential for misuse of the vast amount of personal data it processes. One major concern is the unintended use of data, where data collected for one purpose is repurposed for another without proper consent, leading to privacy violations and even data breaches. Data spillovers, meaning when data meant for a specific context is inadvertently accessible in another, are a particular concern in interconnected systems. Furthermore, AI-powered surveillance technologies, such as facial recognition, introduce privacy risks by enabling ongoing tracking and monitoring, which can erode individual privacy and civil liberties. Inadequate safeguards could create the risk of future liability claims.

[1] https://tnfd.global/AI's Growing Carbon Footprint – State of the Planet (columbia.edu)
[2] Carbon Footprint of Data Centers & Data Storage Per Country (Calculator) (8billiontrees.com)

Systemic risks

A statement by the UN Secretary-General António Guterres emphasised that AI's rapid development without adequate oversight could have "catastrophic consequences" for humanity, potentially even undermining peace and security at a global level.[3] The UK Parliament's Science and Technology Committee report[4] highlighted similar concerns, urging robust governance and international cooperation to mitigate the existential risks posed by advanced AI systems. The report warned that, without proper safeguards, AI could lead to scenarios that surpass human control, resulting in widespread societal harm. While governments and policymakers grapple with these issues, the risk to investors could be that regulation, if introduced, may place greater limitations on the prevailing technological capability.

Governance

Large tech companies are critical to the development of AI, because they develop the foundational models. These same companies frequently have non-standard governance structures – shares might have been issued with minimal or no voting rights, meaning that the company's management has little reason to listen to shareholders. This makes it harder, but not impossible, for asset managers and investors to gain access to management and hold companies to account. It also suggests that encouraging those companies to move to a more standard governance model is an engagement priority.

What can investors do?

While embracing the positive changes that AI brings, asset owners and investment managers should be aware of the breadth and potential longevity of AI-related ESG risks, with appropriate frameworks in place to evaluate these risks and support ongoing engagement with companies. There may be strategic value in focusing on governance-related engagement with tech companies, which could open the door to further engagement.

Asset owners should actively engage with asset managers, asking questions about their views on AI risks and whether they consider AI-related ESG factors when analysing underlying companies. In addition, asset owners should be aware of their asset managers' firm-wide AI policy and how the firm uses AI in its operations, including in its investment or voting decisions. Asset owners should emphasise the importance of transparency and accountability in the use of AI. More information on significant votes relating to AI can be found in our News and Views publication from Q1 2024.

[3] Secretary-General Urges Broad Engagement from All Stakeholders towards United Nations Code of Conduct for Information Integrity on Digital Platforms | Meetings Coverage and Press Releases
[4] The governance of artificial intelligence: interim report - Science, Innovation and Technology Committee (parliament.uk)

SIGNIFICANT VOTES: MODERN SLAVERY IN FOCUS

It's often argued that environmental and governance issues have overshadowed social factors in recent years. There are numerous reasons for this, including the increasingly pressing need, and therefore focus on, addressing climate change. Also, social issues are often deemed more difficult to define and measure. Social issues are, however, highly interconnected with environmental and governance issues. Businesses both cause and are significantly impacted by issues including health and safety, workforce conditions, diversity and modern slavery. Such factors should not be ignored by investors and asset owners.

To assist UK pension funds in better understanding social factors, the Department for Work and Pensions (DWP) set up the Taskforce for Social Factors (TSF) in 2022. TSF published its final guidance in March 2024, aiming to support pensions in assessing the social risks and opportunities of their investments. The guidance emphasises the role of trustees' influence on stewardship practices and their fiduciary duty to integrate financially material social factors into investment decision-making, providing tips on effective stewardship for the consideration of social factors. Modern slavery was used as a case study.

Modern slavery is a human rights violation in which victims are exploited for others' gain, diminishing human capital. It can present in multiple ways including through forced labour, debt bondage, deceptive contracts, withholding wages, child labour, abusive working conditions and human trafficking. Modern slavery is often more prevalent than perceived, as covered in our ESG snippets section, which highlights cases of modern slavery in the UK.

The importance of addressing modern slavery

Modern slavery not only ruins the lives of people but also harms economies, by destroying human potential and removing people from traditional workforces needed to strengthen the economy, risking companies and their supply chains.

Business risks associated with modern slavery are extensive and include:

- reputational risk (which may result in boycotts, protests and customer backlash)
- legal risk (such as fines, criminal charges and litigation)
- financial risk (given potential supply-chain disruptions, increased operating costs, decreased productivity, import bans)

Regulatory change is further increasing the focus on modern slavery, with organisations being challenged to implement appropriate policies and increase disclosures. The UK Modern Slavery Act was developed in 2015 and sets an expectation that businesses, including some pension providers, act to address this issue. The act requires businesses to identify, prevent and mitigate modern slavery along their operations and supply chains and to publish an annual statement reporting on these actions.

Asset owners as stewards of capital

Reputational risks are not only pertinent for companies associated with modern slavery, but also for investors who invest in these companies, as it may reduce their capacity to engage with stakeholders and other responsible investors. Institutional investors are further being driven to determine modern slavery in supply chains as part of their responsibility to respect human rights, as defined by the UN Guiding Principles on Business and Human Rights.

From a fiduciary perspective, systematic human rights violations may undermine the long-term value of a company, and a portfolio, given the increased potential for social unrest and disruption in supply chains. Asset owners should leverage their position as stewards of capital to address modern slavery concerns and consider how investment managers are factoring modern slavery into investment processes and stewardship strategies.

Significant votes

One way to understand investment managers' approach to modern slavery is to review how they have voted on the topic. Over the year, there were several shareholder resolutions that looked to address modern slavery. While none of the resolutions passed, the support seen for these resolutions was significant, outlined in the table below:

Company	Date 2024 AGM	Resolution	Outcome
Nike	10 Aug 2024	**Shareholder resolution (Lead filer: Tulipshare) –** issue a report assessing the effectiveness of existing supply-chain management infrastructure in alignment with Nike's equity goals and human rights commitments.	**Not passed** (13% support)
General Motors	4 June 2024	**Shareholder resolution (Lead filer: Individual) –** report on the extent to which its electric vehicle (EV) supply chain may involve, rely or depend on child labour outside the US.	**Not passed** (13% support)
TJX Companies	4 June 2024	**Shareholder resolution (Lead filer: NorthStar Asset Elements) –** report on the effectiveness of current due diligence in preventing forced, child and prison labour in supply chain.	**Not passed** (6% support)
Ford Motor Company	9 May 2024	**Shareholder resolution (Lead filer: National Centre for Public Policy) –** report on the extent to which its electric vehicle (EV) supply chain may involve, rely or depend on child labour outside the US.	**Not passed** (19% support)
Mondelez	22 May 2024	**Shareholder Resolution (Lead filer: Tulipshare) –** adopt targets and publicly report quantitative metrics to assess whether on course to eradicate child labour from cocoa supply chains.	**Not passed** (22% support)

The consideration of social factors continues to gain momentum among investors and other stakeholders given the associated risks, with issues such as modern slavery rising up the agenda in light of regulatory focus and reputational scrutiny. Asset owners need to understand how exposure to modern slavery is being identified and mitigated as well as how investment managers are addressing human rights issues more generally. Asset owners, and the investment managers that invest on their behalf, should be active stewards, holding portfolio companies accountable to adopting sustainable and socially responsible policies. As a starting point to open discussion, why not ask your investment manager how they voted on the modern slavery-related resolutions tabled at AGMs over 2024, and their rationales for doing so.

ESG SNIPPETS

Social and inequality taskforce launches

The Taskforce on Inequality and Social-related Financial Disclosures (TISFD) launched in September to address the material financial risks to companies and institutions from global inequality. The taskforce's goal is to incentivise business and financial practices that create fairer, stronger societies and economies. It will create a framework – similar to those of the TCFD and TNFD – that will assist companies in disclosing more effectively on impacts, dependencies, risks and opportunities related to social issues, primarily focusing on inequality.

The consideration of social factors continues to gain interest among investors and other stakeholders. Support for increased social disclosure and the impact of social issues on portfolios is gaining momentum. It's important that asset owners utilise existing guidance to help reduce portfolio risk and stay on top of emerging industry best practices and potential future regulations that could impact investments.

Modern slavery found in the UK

The BBC recently uncovered cases of modern slavery in the UK. Signs that victims were being forced to work at a McDonald's branch and a company supplying bakery products to major supermarkets were missed for years. A gang forced 16 victims to work at either the fast-food restaurant or the factory that supplied Asda, Co-op, M&S, Sainsbury's, Tesco and Waitrose. Well-established signs of slavery, including paying the wages of four men into one bank account, were missed, while the victims, from the Czech Republic, were exploited for over four years.

Social factors pose a significant risk to portfolios but are often overlooked compared to environmental and governance factors. Asset owners should ensure their managers actively engage with holdings to address these risks at both company level and within supply chains.

IASB publishes climate reporting guidance

The International Accounting Standards Board (IASB) has published a consultation document providing examples to illustrate how companies can apply IFRS Accounting Standards when reporting the effects of climate-related and other uncertainties in their financial statements. The IASB developed these illustrative examples in response to strong demand from stakeholders, particularly from investors. Stakeholders expressed concerns that information about climate-related uncertainties in financial statements was sometimes insufficient or appeared to be inconsistent with information provided outside the financial statements.

Climate reporting has become increasingly important for companies, asset owners and asset managers over the last decade. Regulations being introduced are increasingly stringent, so it is crucial that asset owners become familiar with what is required of them and prepare for future developments.

GRI and TNFD launch guide for nature impact reporting

The Global Reporting Initiative (GRI) and the Taskforce on Nature-related Financial Disclosures (TNFD) have published a joint interoperability mapping resource that gives a detailed overview of alignment between the TNFD Disclosure Recommendations and metrics and the GRI Standards. The publication looks to support market participants needing, or wanting, to report on their nature-related dependencies and impacts.

Nature and biodiversity present systemic risks to investor portfolios. We encourage asset owners to take an active approach to understanding the nature-related dependencies and impacts of their portfolio in order to manage these risks.

Jaid Longmore
Responsible Investment Consultant
jaid.longmore@hymans.co.uk
0207 082 6103

Sanjay Joshi
Responsible Investment Consultant
sanjay.joshi@hymans.co.uk
0207 082 6017

Andrew McCollum
Investment Research Analyst
andrew.mccollum@hymans.co.uk
0141 566 7776

Important Information

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London | Birmingham | Glasgow | Edinburgh

T 020 7082 6000 | www.hymans.co.uk

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