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CEOs on **strategy and social issues**

Business leaders are now more inclined to incorporate society's expectations into their core strategies but face many challenges when they do.

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Article at a glance

Chief executives have increasingly incorporated environmental, social, and governance issues into core strategies, McKinsey research shows.

These CEOs are responding to increasing pressure from employees and consumers, but some also see opportunities to gain a competitive advantage and address global problems.

CEOs view globalization as the key development reshaping the contract between business and society. They identify talent constraints, poor public governance, and climate change as the issues most critical for their companies to address.

Competing strategic priorities and the failure of financial markets to recognize the importance of implementing a strategic approach to societal issues are among the barriers to change.

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Chief executives around the world increasingly believe that they have a strategic rationale for taking on environmental, social, and governance[1] issues. However, they also understand the challenges that must be overcome when they do—challenges that include the difficulty of managing supply chains across countries with different regulations and norms for corporate social responsibility.[2]

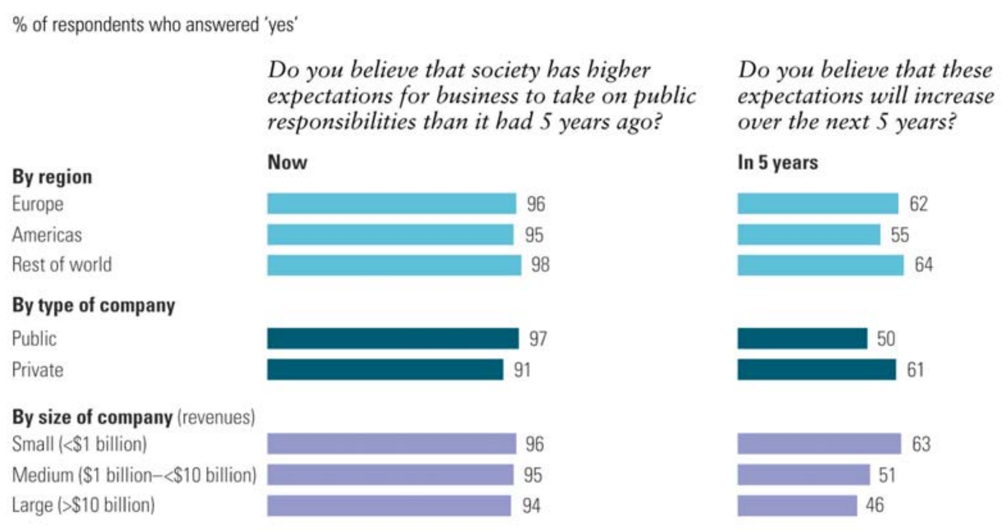
According to our survey[3] of CEOs at companies participating in the United Nations Global Compact,[4] more than 90 percent of them are doing more than they did five years ago to incorporate environmental, social, and governance issues into their core strategies. Our research[5] shows that while pressure from employees, consumers, and other stakeholders plays an important part in this trend, some CEOs see the new demands as opportunities to gain a competitive advantage and to address global problems at the same time.

Great expectations

According to 95 percent of the CEOs in our survey, society has greater expectations than it did five years ago that companies will assume public responsibilities. More than half predicted that these expectations would increase significantly during the next five years as well. Low levels of trust among consumers underscore the pressure to act. In a 2006 McKinsey global survey, for example, only 33 percent of European and 40 percent of US consumers said they believed that large global companies acted in the best interest of society at least some of the time.[6]

EXHIBIT 1

Societal expectations



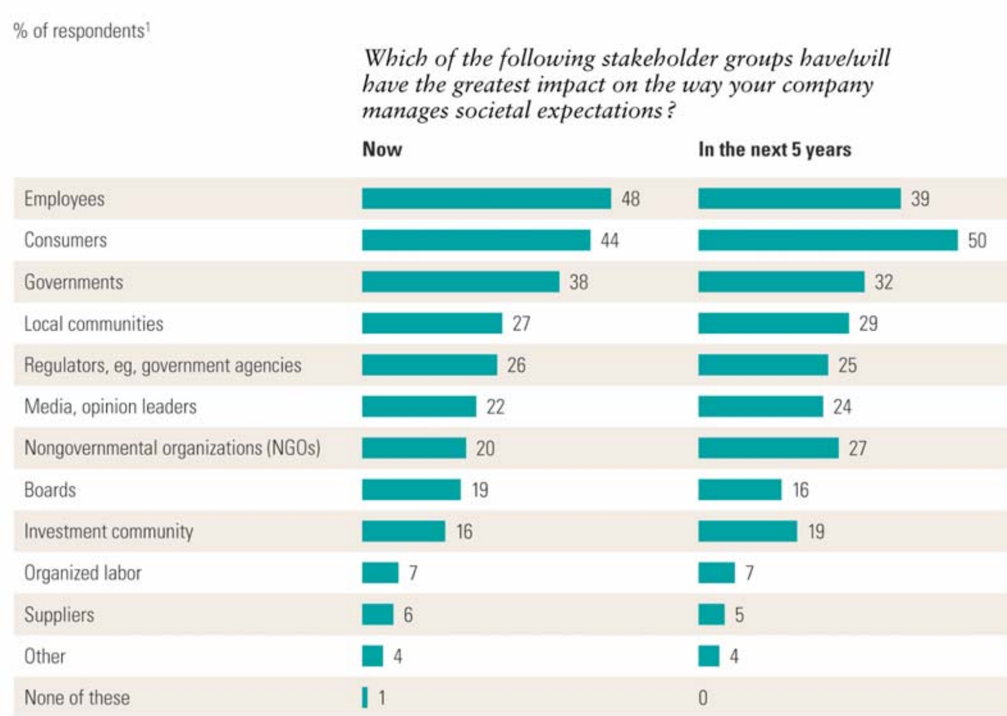
Source: Feb 2007 McKinsey survey of 391 CEOs whose companies participate in UN Global Compact

A new class of stakeholder

Many of the CEOs we interviewed observed that satisfying the shareholders is no longer good enough: consumers will punish companies that don't fulfill their public responsibilities, causing their market shares to decline. Socially irresponsible business practices could also make it harder for companies to attract and retain talented people. "It is important," said the CEO of a retailer, "for our employees to know and see that they are working for a company where these things are held to be important." CEOs ranked employees as the stakeholder group that has the greatest impact on the way companies manage their societal expectations, with consumers a close second. Both groups are joining nongovernmental organizations and activists in making increased demands on companies. Over the next five years, respondents expect consumers to become the most influential stakeholder group, with employees dropping to second place.

EXHIBIT 2

Stakeholder impact



[1] Respondents were allowed to select up to 3 stakeholders.

Source: Feb 2007 McKinsey survey of 391 CEOs whose companies participate in UN Global Compact

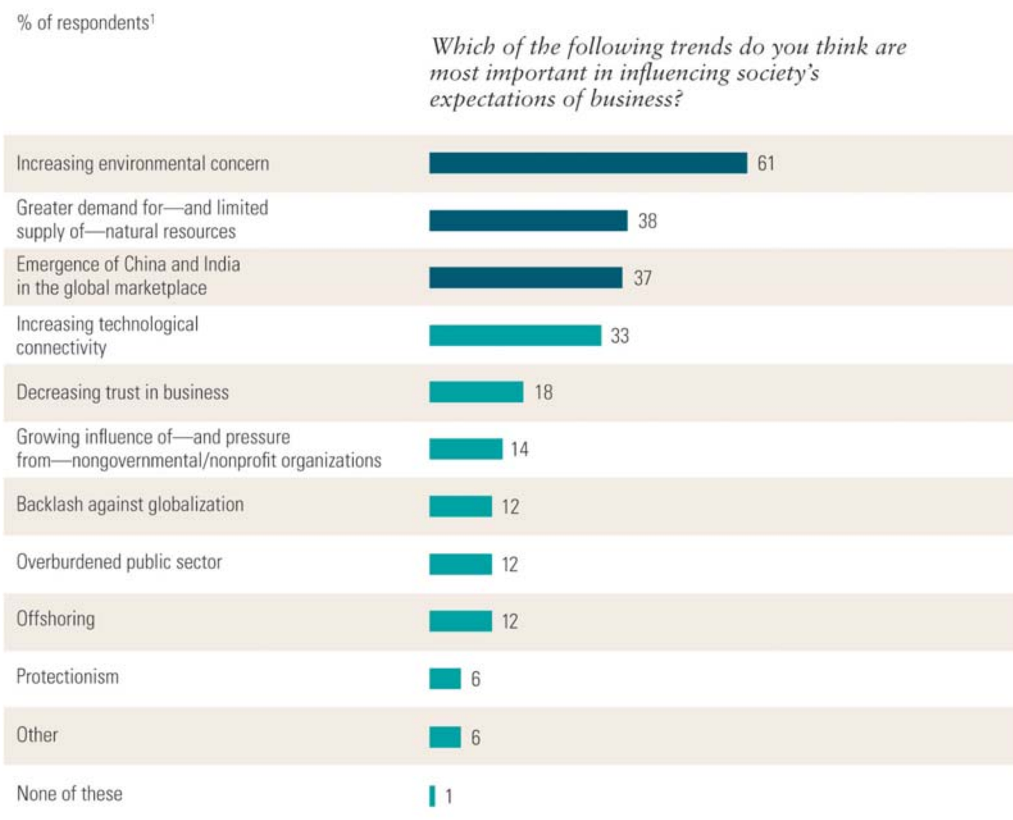
Globalization ups the ante

The terms of the contract between business and society have undoubtedly become more extensive and complex: difficult environmental, social, and governance challenges have accompanied the rise of emerging economies, which are both drivers of global demand and providers of goods, services, and talent. CEOs in our survey identified increasing environmental concerns as the most important trend influencing public expectations of business, followed by the limited supply of natural resources and the emergence of China and India as powers in the global marketplace.

Clearly, companies operating in these countries will be affected by local interpretations of environmental, social, and governance norms. They will have to find ways of demonstrating their local loyalties and, at the same time, build globally integrated systems of values.

EXHIBIT 3

Trends influencing society's expectations of business



[1]Respondents were allowed to select up to 3 trends.

Source: Feb 2007 McKinsey survey of 391 CEOs whose companies participate in UN Global Compact

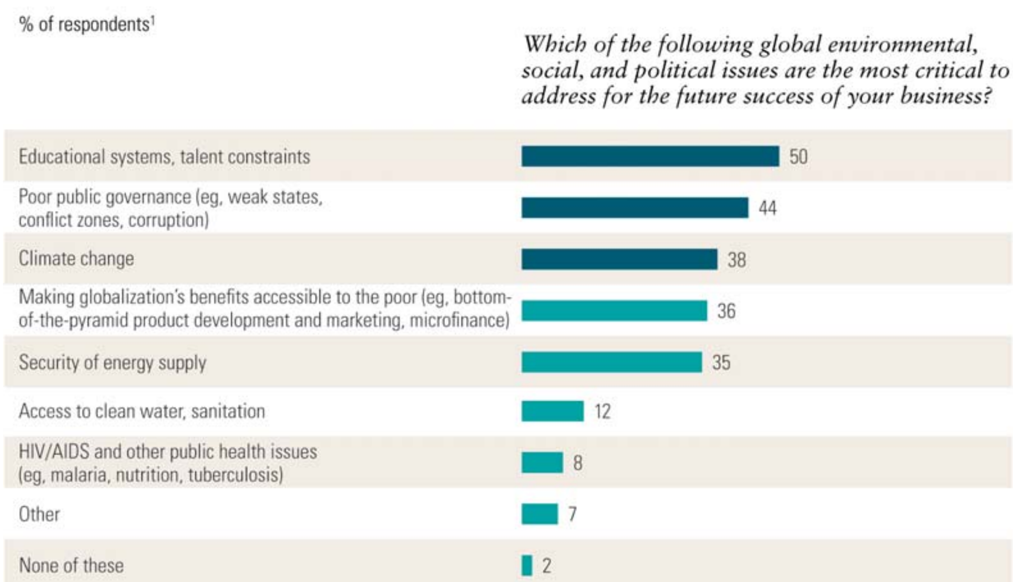
Critical for success

The approach a global company takes in dealing with cross-border environmental, social, and governance issues, many of which demand both systemic change and sustained engagement by business, may affect not only its reputation but also its competitive position. A company that offers better working conditions and health care benefits than local norms stipulate, for example, may have an easier time finding skilled employees in areas with limited educational systems. Likewise, a company that invests in water conservation may be protecting vital resources for continued growth. As the CEO of a consumer-packaged-goods company said, "Water is the biggest issue for our company right now—the ability to do business in water-stressed areas is critical to our growth."

CEOs in our survey identified talent constraints, poor public governance (such as corruption or underdeveloped legal and judicial systems), and climate change as the most critical environmental, social, and governance issues their companies must address to succeed in the future.

EXHIBIT 4

Address for success



[1]Respondents were allowed to select up to 3 issues.

Source: Feb 2007 McKinsey survey of 391 CEOs whose companies participate in UN Global Compact

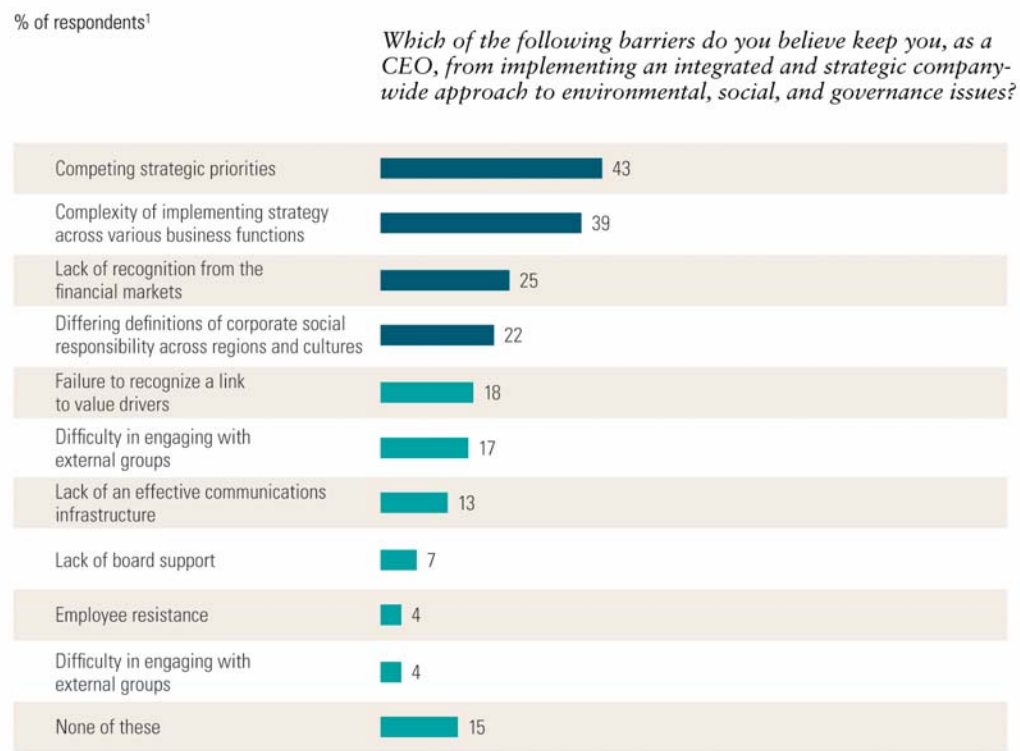
Barriers to engagement

These challenges seem daunting enough, but the barriers to implementing strategic approaches to them—approaches representing sustainable wins for companies as well as for society—are formidable too. Competing priorities are the biggest impediment. Shareholder demands for strong short-term financial performance, for example, compete with environmental, social, and governance investments that are longer term by nature. The absence of clear and consistent metrics that could relate such investments to (or correlate them with) investor returns exacerbates this conflict. In fact, fewer than one-fifth of the CEOs we surveyed believe that financial markets account for the way a company approaches environmental, social, and governance issues when they value it. As the CEO of a financial institution noted, the standards that do exist[7] have "yet to become benchmarks to look up in the *Wall Street Journal*, where we can see, alongside stock prices, that a company's ESG [environmental, social, and governance] impact rating went from 2 to 12, and this somehow becomes a factor in how we value it."

Another barrier is a lack of consistent industry regulations (or even norms) that might level the playing field across countries. One CEO described this complicated state of affairs by saying, "The world is not flat, but quite hilly." Companies that wish to deploy tough international norms (on labor practices, for example) therefore face a significant risk of losing out to less scrupulous noncompliant competitors.

EXHIBIT 5

Barriers to CEO engagement



[1]Respondents were allowed to select up to 3 issues.

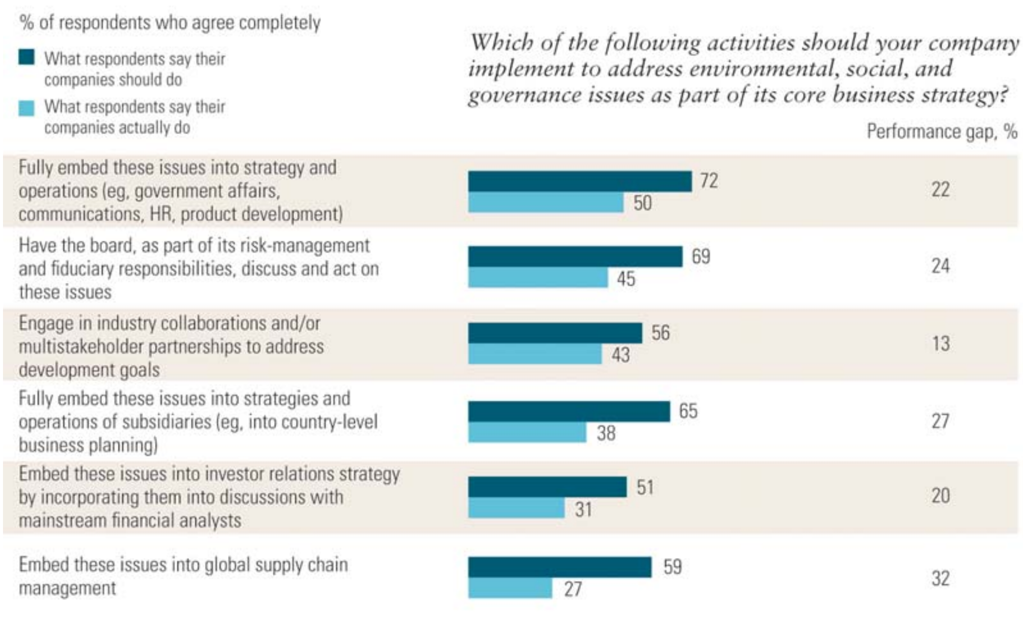
Source: Feb 2007 McKinsey survey of 391 CEOs whose companies participate in UN Global Compact

Performance gaps

Substantive challenges await any company bent on translating its good intentions into good deeds. While 72 percent of the CEOs we surveyed said companies should fully incorporate a stance on environmental, social, and governance issues in strategies and operations, only 50 percent said that their own companies actually do. Changing the practices of suppliers is particularly complex. First, as the CEO of a manufacturing company said, "There are questions about how far up and how far down the supply chain responsibility goes." Moreover, if a company does decide to implement a global code of conduct, local suppliers often ask why they should invest in equipment or more humane management practices to suit the whims of the customer. While 59 percent of the survey respondents believe that their companies should incorporate environmental, social, and governance issues into the management of supply chains, only 27 percent say that those companies actually do.

EXHIBIT 6

Performance gap



Source: Feb 2007 McKinsey survey of 391 CEOs whose companies participate in UN Global Compact

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The barriers to implementing strategies that benefit companies as well as society often seem very hard to overcome. Yet during our research we found that many businesses are developing creative and commercially viable solutions for addressing issues such as water conservation, biodiversity management, finance for the poor, and treatment of HIV/AIDS. These corporate pioneers are redrawing the global playing field around a new set of competitive advantages and relationships with consumers.

[1] These include global public-governance issues (such as different regulations and norms in different countries), local public-governance issues (such as corruption or underdeveloped legal and judicial systems), and corporate-governance issues.

[2] The full report underlying this article, *Shaping the New Rules of Competition: UN Global Compact Participant Mirror*, is available free of charge online.

[3] The 391 survey respondents represent 230 organizations with headquarters in Europe, 73 in the Americas, 47 in Asia, 25 in Africa, 9 in the Middle East, and 7 in Australasia. They include 275 private and 79 public companies, 28 state-owned ones, and 9 nonprofits.

[4] The United Nations Global Compact is an initiative, established in 2000, to encourage businesses around the world to adopt sustainable and socially responsible policies and to report on them.

[5] In addition to the survey, we conducted in-depth interviews with leaders of 38 organizations participating in the United Nations Global Compact. Thirty-one of them were companies (24 multinational and 7 national) and 7 were civil-society organizations.

[6] Sheila M. J. Bonini, Kerrin McKillop, and Lenny T. Mendonca, "The trust gap between consumer and corporations," *The McKinsey Quarterly*, 2007 Number 2, pp. 7–10.

[7] Initiatives such as the Goldman Sachs global ESG framework have made progress bringing environmental, social, and governance issues into the mainstream of the capital markets. The Goldman Sachs framework is designed to incorporate such issues into industrial analysis and valuations on a sector-by-sector basis.

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