Governance—at the Heart of ESG

The Confluence of E, S and G: How Environmental and Social Trends Require New Governance Structures

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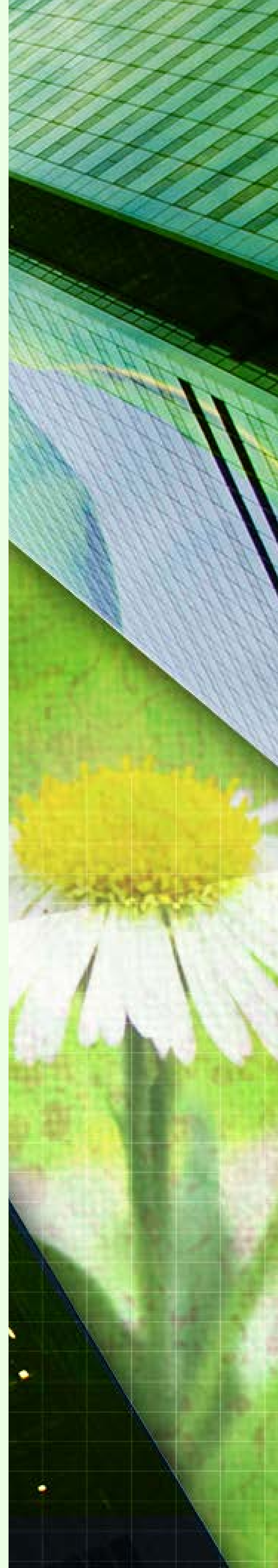


Environmental, social, and governance (ESG) considerations are seldom out of the news. Organizations of all types have developed or are developing programs and plans to address ESG. The issues are wide-ranging, complex, and intertwined. Company boards should take a firm leadership position on the matter, putting in place clear governance strategies and strong processes or frameworks to support them.

Eurasia Group was pleased to work with international law firm Reed Smith on this report. Its objective is to help organizations manage the many current ESG issues and prepare for the new governance structures required to keep abreast of ever-changing environmental and social trends.

Overview

Whether they are viewed as positive or negative, ESG considerations are seldom out of the news these days. Now familiar corporate concerns (such as climate change, gender equality, and workforce diversity) are being supplemented by newer ones such as biodiversity, water use, plastics management, and financial inclusion. Firms' positioning on gender rights, reproductive rights, work-from-home, the war in Ukraine, and other issues that might previously have been deemed "political" rather than corporate entails a new type of decision-making. In such an environment, the most important component of the ESG troika is governance (G). E and S create both risks and opportunities for companies (and those that invest in or work for them), while G issues get to the heart of how opportunities are identified and risks are managed.

There are various schemes aimed at characterizing and assessing (good) governance—in general and in the rapidly changing environmental and social space—but there is not yet a universally accepted standard. There is also an important divergence emerging between what might be characterized as ratings- or compliance-oriented good governance and governance that materially helps with risk management and value creation. Such governance requires new vigilance, new skills, and a very adaptive approach to an evolving corporate and natural environment.

"Good governance" has been on the agenda for more than 30 years

Investors and businesses themselves have long understood that good governance underpins superior financial performance and is essential to limit downside risk. Around 1990, the landscape changed with more explicit discussion of the importance of corporate governance and greater attempts to codify standards, including by the Business Roundtable

in the US. The International Corporate Governance Network was established by investors in 1995, and two years later, the Global Reporting Initiative began work on establishing global best practices for organizations in communicating about and demonstrating accountability for the impact they have on the environment, economy, and people. The OECD issued its Principles of Corporate Governance in 1999 and updated them in conjunction with the G20 in 2015 (with a further revision due this year). Meanwhile, the UN Principles for Responsible Investment were launched in 2006, and the World Economic Forum now hosts an active Global Future Council on the Future of Good Governance (with the double "future" suggesting that this issue is not going away any time soon).

Over the years, the world has also received some very painful reminders of the importance of effective governance (and corporate integrity), including, for example: the fall of Enron in 2001 and the subsequent demise of accounting major Arthur Anderson; the collapse of Lehman Brothers (and near collapse of many other financial institutions) in 2008; the role of Purdue Pharma in creating the opioid crisis from the mid-1990s onward; and Volkswagen's "dieselgate" scandal in 2015.

The range of issues that require oversight is growing

Established "good governance" concerns (principally oriented toward traditional financial outcomes deemed to be affected by a relatively narrow range of issues) have been supplemented and augmented by an intensifying focus on financially material environmental and social issues. From the 1990s to the 2000s, these felt like "add-on" issues, "nice-to-haves" that could be parked with the Corporate Social Responsibility department. Over the past two decades, driven at least in part by a shift in investor attitudes, the situation has changed dramatically with the recognition that these are material, systemic concerns for companies (and their investors) that require focused governance attention.

Such issues are critical to several stakeholder groups:

- legislators and regulators, who establish norms or laws governing corporate behavior;
- customers, who want their purchasing decisions to reflect their values;
- staff, who want to work in companies whose corporate values align with their own;
- investors, who may also make decisions based on certain values or who may track companies' management of environmental and social issues because they understand these to be important for financial success as the energy transition unfolds, as the groups listed above become more vocal, and as the effects of breaching planetary ecological boundaries become more evident; and
- philanthropists and foundations that seek to influence public and corporate policy as well as create an environmental and/or social impact.

A legal perspective on the shifting sentiment toward ESG

This shift in sentiment has been reflected in developments in corporate law. Historically, the overarching duty of company directors was to promote the interests of shareholders, which was generally understood to mean financial interests expressed in terms of dividend income and capital appreciation. Reflecting the broadening role of corporate responsibility in respect of the environment and society, corporate law has broadened the scope of the duties of those responsible for the success of the enterprise.

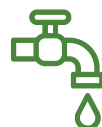
For example, in the UK, Section 172 of the Companies Act 2006 introduced several factors a company director must consider in promoting its success. While promotion of the company continues to be for the benefit of its members as a whole, directors must, among other things, also take into consideration the interests of employees, the need to foster business relationships with suppliers and customers, the impact of the company's operations on the community and the environment, and maintaining a reputation for high standards of business conduct.

The directors' obligation to perform these duties was further emphasized with additional legislation in 2018. It requires larger firms to provide a statement in their strategic report for a financial year describing how the directors have addressed the matters described above when performing their duties under Section 172. This statement goes beyond an obligation merely to confirm that the duty has been performed in accordance with the law; it requires the company to explain the way that the statutorily specified factors have been taken into account. While aimed at bigger companies, the obligations are reflected in corporate governance codes, reinforcing the expectation that good governance is not all about profit for shareholders at all costs.

E for environment

Climate change has been the leading issue.

Although some companies had already been thinking about it for many years, the issue moved to the forefront in 2015 when Mark Carney, in his capacity as chair of the Financial Stability Board, recognized climate as a systemic risk to global financial stability and launched efforts to track, disclose, and manage environmental risk at both the firm and system level. Increasing recognition that the world of tomorrow will look very different from the world of today has increased the focus on understanding and managing climate-related financial risk while also identifying new commercial opportunities that will inevitably emerge as decarbonization takes hold.



Water is a rapidly growing concern.

Water stress has become acute globally—partly because of climate change and partly because of years of poor management and excessive extraction that have depleted aquifers and led to a drastic shrinking of reservoirs. In recent years, rivers have run so low in Europe that nuclear reactors can no longer be cooled. Water levels in the US's second-largest reservoir, Lake Powell on the Colorado River, reached a new low in February, revealing more than 100,000 acres of previously submerged land and necessitating unprecedented cuts in water usage from surrounding states. Many production processes and companies use vast amounts of water—a resource for which they increasingly compete with agricultural and real estate needs.

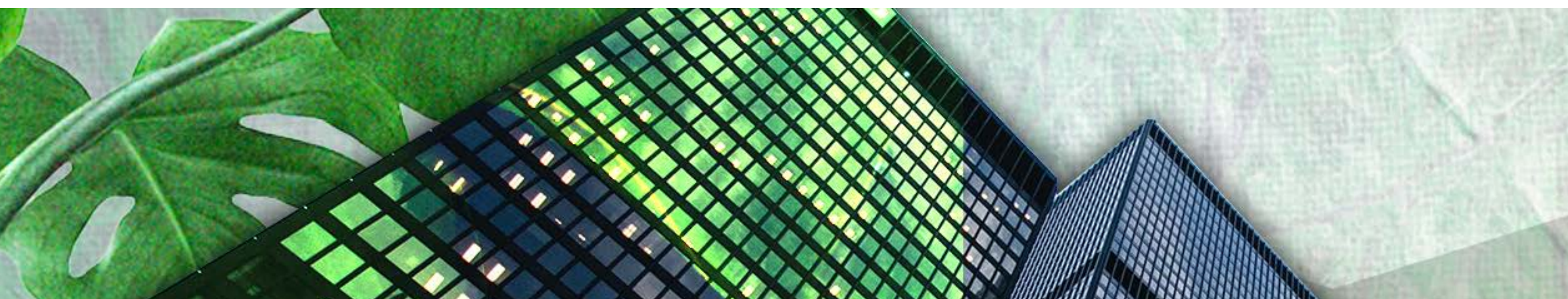
Biodiversity has become a more prominent concern in the wake of climate change.

People have realized that just as climate stability cannot be taken for granted, neither can ecological stability; the collapse of ecosystems may be as much of a business risk as a climate variability. The World Wildlife Fund estimates that wildlife populations declined by as much as 70% since 1970.[1] This alarming pace of global biodiversity loss threatens individual companies and broader sectors, from agriculture/food production to pharma and beyond. The overall effect of ecosystem collapse is extremely hard to predict with accuracy. However, potential knock-on effects and tipping points pose serious business risks, given human dependence on natural resources for food, medicine, and clothing, as well as regulating environmental systems.

Plastics are also gaining international attention.

In 2022, 175 countries, including the US and China, started negotiations on a global, legally binding treaty on plastics pollution. The goal is to adopt a treaty by 2024, and the processes surrounding the treaty are likely to drive new country- and city-level plastics regulation ranging from bans to disclosures. The EU is leading the pack, building on its ongoing policy leadership through the Packaging & Waste Directive, its forthcoming Corporate Sustainability Due Diligence Directive, and potentially its Carbon Border Adjustment Mechanism as its scope broadens over time (the first iteration does not cover plastics/petrochemicals).

1 https://www.worldwildlife.org/press-releases/69-average-decline-in-wildlife-populations-since-1970-says-new-wwf-report



A legal perspective on climate legislation and broader disclosure requirements

The leading role of climate change in the environmental and broader ESG space is reflected in the advanced level of legislation and regulation in this area. Financial regulation is at the vanguard of compliance, partly because investment is seen as a key agent of change. Regulations such as the Sustainable Finance Disclosure Regulation, the amended Markets in Financial Instruments and Alternative Investment Fund Managers Directives, and the EU's proposed green bond standard seek to channel money into environmentally ameliorating activities. They also represent a recognition that investment in and the financing of climate-affected economic activity threatens the financial system, as shown by climatic stress testing for financial institutions, climate-specific reporting for loan books, and enhanced environmental disclosures in financial reports.

In the non-financial corporate world, disclosure seems to be the means for cajoling enterprises to embrace the virtue of sustainability. Most of the relevant legislation focuses on carbon reduction, such as the inclusion of recommendations by the Task Force on Climate-Related Financial Disclosures (TCFD) in corporate financial reporting and the implementation of the Sustainability Disclosure Requirements regime, which heralds an uptick in mandatory corporate disclosure across the broader corporate environment. Not all corporate disclosure is compliance driven; much remains voluntary. Voluntary corporate disclosure is often altruistic or developed to align with an organization's ESG strategy, to enhance its brand, or to respond to stakeholders' expectations. However, disclosure is increasingly being deployed as a corporate shield to defend companies from actions by activist stakeholders. Companies can find themselves in a pincer movement of assertions that they have failed to adequately disclose the environmental risks to their activities or the environmental damage they inflict, while rendering themselves vulnerable to actions prompted by a failure to address adequately (or at all) the risks they have disclosed.

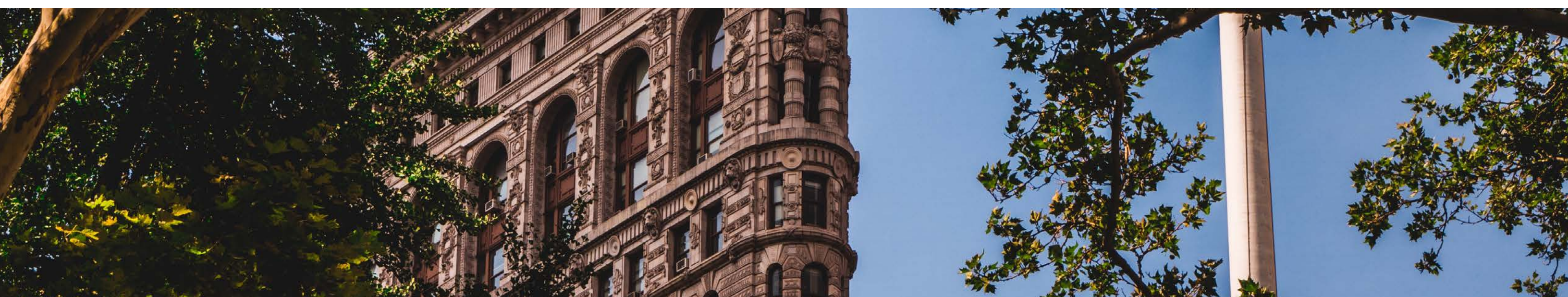
S for social

The S in ESG pertains to a number of diverse stakeholder groups: workers (and the related issues of pay parity, equal rights, diversity, equality, healthcare, safety, training, and education); suppliers (ensuring that suppliers uphold equity, diversity, and safety standards); customers (product safety and mitigating product gender or racial stereotyping); society in general (the impact of products on the broader population as well as on particular groups, such as indigenous communities—the big issues here being firearms, misused prescription drugs, and now plastic/chemical pollution); and marginalized communities (providing access to infrastructure, sanitation, education, housing, food/good nutrition, and healthcare, as well as not unduly harming disadvantaged socioeconomic groups that tend to live close to industrial facilities).

Over the past year, human rights issues have moved to the forefront for companies. This has been triggered in part by human rights abuses. Lawmakers in Europe and the US are showing greater willingness to hold companies accountable for human rights abuses and forced labor in their supply chains. Regulators and legislators are imposing import bans on goods with questionable provenance. For example, in 2022, the US passed the Uyghur Forced Labor Prevention Act targeting exports from China's Xinjiang province. Firms importing goods into the US from the area must prove a lack of forced labor in the supply chain. The UK had already passed its own Modern Slavery Act in 2015, which placed obligations on corporations in relation to their supply chains. In September 2022, the EU proposed a similar yet geographically broader forced labor ban; other jurisdictions are expected to follow suit to maintain their own standing with major importers. These policies require a new level of understanding and oversight of suppliers on the part of companies and imply a higher level of jeopardy and financial risk for boards.

Corporations are, at the same time, increasingly expected to take a stand or develop a position on socially impactful legislation (for instance, gender issues, what can be taught in schools, indigenous rights, employment law, etc.). They are likewise expected to ensure that their own political contributions and lobbying efforts are consistent and fully aligned with this stated position.

These newer issues come in addition to longstanding concerns about workplace diversity, equity, and inclusion. Gender and racial pay gaps are heavily scrutinized, alongside measures to promote overall staff diversity—and particularly diversity within executive teams and boards themselves. This includes the question of whether management teams are as diverse as overall staff. Such issues are important (for investors) both because employers may find it harder to attract talent if they fall short on social issues, and because increased cognitive diversity is viewed as conducive to better performance. Regulations that require corporate diversity are emerging in Europe and the US, as well as investor proxy voting guidelines that demand more board diversity.



A legal perspective on social impact

One of the challenges in devising an ESG strategy is discerning the reach of its social aspect. This is not simply a case of definitional semantics. Without a commonly accepted social taxonomy, enterprises find it challenging to particularize their aims and achievements in the "S" area. Internally, some components of good corporate governance can equally be seen as enlightened social policy—for example, employee welfare or diversity. Although this might be considered a virtue, it is also open to claims of "social washing." There is also a balance to be struck between compliance with social legislation and seeking to promote this as a proactive part of an external-facing ESG policy. Legislation on modern slavery, forced labor, anticorruption, and bribery is introduced by governments to promote national social aims, frequently as part of their manifesto. Companies have little choice but to comply with their mandatory obligations under such legislation, so care must be taken in portraying compliance as a positive contribution to avoid the charge of double dipping in both the compliance and ESG pots.

The EU's approach of dual materiality—considering not only the impact of environmental and societal factors on an enterprise but also the enterprise's impact on the environment and society—is relatively clear in environmental matters, particularly as they pertain to climate change. It is harder to articulate a strategy for considering and assessing an enterprise's societal impact, particularly when seeking to develop metrics for measurement and assessment. Given these issues, an EU Social Taxonomy is years behind the already-published EU Taxonomy, which focuses on environmental standards.

Similarly, while a common trajectory might be discernible in relation to climate change (if only for it to be ignored or denied), it is harder to achieve a comparable quasi-consensus on societal change. This presents a significant challenge for firms seeking to implement a transformative external societal strategy as part of their approach to ESG. First, there are differing views on whether such changes are necessary or even desirable. Second, there are differing norms and values among regions, cultures, and ethnic groups, making it difficult to produce a coherent and consistent approach for multinational organizations. Third, areas of focus for an enterprise's activities in the social space can impinge on government policies, risking the politicization of corporate strategy. Furthermore, articulating a principled and positive engagement with society in an ESG strategy must be done in the context of societies that are themselves fluid and dynamic in the unstable environment of a post-pandemic world.

Access to financing is likely to be a key driver of social impact investments. The newly released Social Loan Principles, jointly presented in February by the Asia Pacific Loan Market Association, the Loan Market Association, and the Loan Syndications and Trading Association, are a catalyst for defining the scope of social loans. They build on the Equator Principles (EP4) issued in 2020, which offer a framework for signatory financial institutions to assess the environmental and social impact on their financing transactions depending on the type of financing (for example, project finance, project-related corporate loans, bridge loans, and project-related acquisition finance).

Do ratings agencies help distinguish the good from the bad in managing ESG issues?

Given the burgeoning expectations for ESG, it is not surprising that investors and regulators are increasingly turning to third-party agencies to rate corporate performance. In response, more and more firms are coming to market to analyze and manage data (through AI algorithms and otherwise) and produce their own proprietary ESG rating systems.

On the environmental (and especially the climate) side, there is reasonable agreement and growing regulatory alignment, as well as more data available—which should help the ratings agencies. Eurasia Group analysis finds that 19 countries have some form of mandatory climate-related financial disclosure in place or in development. Bodies such as the TCFD and, if expectations prove correct, the new International Sustainability Standards Board (ISSB) are succeeding in creating internationally accepted norms. A similar effort is underway in the biodiversity space, with the Taskforce on Nature-related Financial Disclosure (TNFD) due to release its final report in the fall, with likely mandated disclosures to follow.

The EU has the most extensive and complex environmental and social disclosure guidelines. The bloc's Sustainable Finance Disclosure Regulation and associated EU Taxonomy require complex analysis and reporting on the part of both corporations and investors. The EU Social Taxonomy Regulation and the Corporate Sustainability Reporting Directive, as well as complementary sustainability regulations such as the Corporate Sustainability Due Diligence Directive, will create significant pressure on companies to improve transparency and performance on social factors in the coming years.

But all these E and S disclosures—and actions—still need managing, and the challenges on the governance side are far greater.[2] There is limited agreement as to "what good looks like." This is especially concerning since governance is the part of the ESG troika on which the other two legs largely depend.

The World Economic Forum notes that many governance indicators stem from a time before the world began to focus intensely on ESG, limiting their value today. Historically, attention has been focused on corporate structure, board composition, business ethics, and anticorruption policies, but good ESG governance extends well beyond these issues.[3] Ratings firms typically award points to multiple brackets to create a quantitative governance score, but both the brackets and what is desirable within the brackets can differ. Below is an overview of some of the leading indicators:

- **MSCI** divides its evaluation into corporate governance (board, pay, ownership, accounting) and corporate behavior (business ethics and tax transparency).
- **S&P** evaluates governance in four sections: structure and oversight, code and values, transparency and reporting, and cyber risk and system.
- **Sustainalytics** reviews board/management quality and integrity, board structure, ownership and shareholder rights, remuneration, audit and financial reporting, and stakeholder governance.
- **Ecovadis** examines the operating practices and standards of a company, looking for those that are self-auditing, consistently measure and evaluate performance, maintain regulatory relationships, practice risk management, and are compensated for achieving ESG goals.

2 Governance remains the least likely recommendation in the TCFD framework to be disclosed, especially in North America and Latin America. TCFD Status Report (2022)

3 WEF (2022) *Defining the 'G' in ESG: Governance Factors at the Heart of Sustainable Business.* The full list cited in the document is: business ethics; board composition; corporate leadership; risk and crisis management; resource allocation; incentive structures; political responsibility; transparency; anticorruption and integrity; tax strategy; fair competitive practices; stakeholder engagement; and supply/value chain management. The authors explicitly caution against treating this list as a checklist, urging attention to be paid to "how [these factors] are executed in practice" so that compliance does not replace meaningful action.

A legal perspective on ratings and the regulation of raters

In light of the proliferation of ESG ratings and their providers and the lack of transparency and comparability, it is hardly surprising that there have been calls to regulate the providers of ESG ratings. After all, the argument goes, credit rating agencies are regulated as are administrators of financial benchmarks, so why should ESG ratings organizations not be brought within the regulatory net? The proposals have been gaining ground: At the end of 2022, the UK government announced the Edinburgh Reforms, a comprehensive review of the country's financial regulatory framework post-Brexit. Within the package was a proposal for a consultation to bring ESG ratings providers within the purview of the Financial Conduct Authority and for the Treasury to join the ESG data and ratings code of conduct working group.

Meanwhile, the International Organization of Securities Commissions has published recommendations on how to regulate ESG ratings agencies, and last year the European Commission conducted a targeted consultation on the functioning of the ESG ratings market in the EU. Given the lead that the financial sector has been given (or assumed) in promoting sustainability and decarbonization, the focus to date has been on financial regulation.

In addition, the fact that several credit rating agencies are involved in the ESG ratings market, either as a standalone activity or as part of their overall credit rating process, has reinforced that view. However, as ESG compliance continues to extend to the broader corporate community, does subjecting ESG raters to a financial services regime make sense, particularly as many of their metrics and inputs are not financially or investment oriented? Although there is an element of objectivity in credit ratings, ESG ratings are inherently subjective, and it has been suggested that they are closer to opinions (though not in the legal sense) as to the ESG status or direction of travel of an enterprise or an investment portfolio than they are to objective benchmarking. This ambiguity in the interpretation and functioning of ESG ratings increases when the interaction among the E, S, and G are factored in.

While it may be possible (albeit not easy) to measure the rate of a company's decarbonization in isolation from its other sustainability activities, how an ESG rating model weighs that decarbonization activity as part of or against that company's commitment to achieving a just transition depends on the weighting given to the two activities and the way the E and the S interact in the overall ESG ratings model. The weighting algorithms are not the only source of divergence for ESG assessments, particularly in any form of indexation of ESG attributes; an index that takes a snapshot of the ESG factors that are present (or absent) at a given time may allow improvement to be measured by taking a camera roll of snapshots over time. But it is very different than one that measures the impact or velocity of change on the society or environment.

Those arguing for regulation of ESG ratings as a panacea for a lack of consistency or comparability may not be happy with the result. Investors, consumers, and the broader community of direct and indirect stakeholders are attracted to ESG ratings as a straightforward and transparent instrument of assessment. It would be a step backward if the regulations seeking to bring that about were themselves excessively opaque and complex.

Avoiding governance pitfalls: Focusing on outcomes, not on ratings

With such a rapidly growing number of issues that require oversight, a lack of familiarity on the part of those doing the oversight, and no consensus on what should be measured, a broader concern emerges: Some firms may end up focusing on form over substance. They may orient themselves toward compliance rather than establishing governance structures and processes that are truly aligned with the challenges at hand. Indeed, the complexity and lack of clarity firms face may actively encourage them to target the known (a high governance rating) rather than the unknown or unknowable (a structure that is aligned with effective outcomes).[4]

This dynamic leaves room for three scenarios regarding governance of systematic environmental and social risks:

1 A company **does not** have adequate ratings-based governance or outcome-based governance.

2 A company **has** ratings-based governance but not outcome-based governance.

3 A company **has both** ratings-based governance and outcome-based governance.

Particular skills and approaches, as well as different corporate cultures, are likely to be important in enabling firms to move from scenario 1 to scenario 3 (bypassing scenario 2) and establishing themselves firmly in scenario 3—and thus build value through their efforts.

Below is an assessment of why the underlying issues are hard to manage, as well as the contours of good, outcome-oriented corporate governance.

Why these concerns are hard to manage

The evolving understanding of systematic financial risk from environmental and social issues has exponentially increased the difficulty of corporate governance. These issues are layered on top of—and deeply entwined with—an existing broad slate of governance issues around financial performance, strategy, political risk, technology, and cyber threats, to name but a few. Overseeing the financial performance of a firm is already a challenge, but ensuring effective oversight of increasingly financially material environmental and social issues takes it to a new level.[5]

Several factors complicate the task at hand:

- **The past provides less and less guidance for the future:** Environmental and social risks are exacerbated by the delinking of what has gone before and what seems likely to lie ahead (owing to exponential shifts in both social attitudes and physical conditions). For example, traditional hydrological analysis typically requires historical water data to provide assurance that sufficient groundwater reserves exist to support business development. With climate disruption, and resulting changes in water allocation and pricing policies, companies must extrapolate into the future, requiring judgment calls. There are similar uncertainties about social risks. Shifting cultural sentiments regarding labor rights, gender equality, and racial discrimination have made the future hard to predict, especially given transformations in technology and transparency. Human rights violations can now be tracked throughout the value chain and amplified through social media, creating much greater jeopardy for firms and a much larger need for scrutiny, even at the far reaches of supply chains.

4 See, for example, *British Journal of Management, Vol. 00, 1–30 (2023)* ***Board Sustainability Committees, Climate Change Initiatives, Carbon Performance, and Market Value***, which finds that those firms with board-level sustainability committees actually perform worse on climate outcomes than those that do not.

5 One area of general agreement is that E and S issues are themselves drivers of financial performance (though there may be some dispute about the direction in which they are heading: There is notable disagreement between those that feel they are a drag on shareholder returns and others who think good performance on ESG is the key to long-term financial success).

- **Complex, systemic issues are hard to understand, measure, and track:** Biodiversity in particular is variable across areas, is affected by collections of actors, responds in ways not fully understood, and cannot be reduced to a single metric (although the "30 by 30" agreement to protect 30% of biodiversity on land and sea by 2030, agreed at the UN biodiversity summit (COP15) in Montreal, begins to address this issue). Most companies are not equipped to understand where and how biodiversity loss and laws that protect biodiversity will affect their business. They have neither the expertise nor the structures in place to monitor an issue that may be exponentially more challenging than understanding climate-related risks. That said, the latest iteration of the TNFD draft guidance does a good job of creating a relatively simple set of indicators for firms to track.

- **Highly polarized viewpoints on both environmental and social issues make it hard for companies to tread the right path:** The current furor around ESG itself is a case in point. Firms that operate in Europe are penalized for not taking full account of ESG issues, while the same companies are excluded from investment in certain US states because they do consider ESG.

- **Solutions in one area can cause problems in another:** Solutions for environmental and social issues can overlap (for example, Knorr's Future 50 Foods report identifies 50 foods that boost the nutritional value and reduce environmental pressure); however, they can also conflict. Concerns about forced labor in solar panel supply chains may conflict with the need to accelerate renewable energy deployment. Similarly, plastic beverage containers weigh less and use less carbon to transport than glass, but they create other environmental issues. Addressing multiple factors simultaneously requires companies to avoid siloed decision-making.

- **Many companies face a complex array of regulations and voluntary standards issued from various bodies across multiple jurisdictions:** US and European (and other) regulations are seldom fully aligned, and with the advent of more muscular domestic (and even cross-border) industrial policy, this is unlikely to be a temporary problem. There are also an expanding number of "third sector" standard-setting bodies with considerable heft (such as the Science Based Targets initiative) and the various entities working around the voluntary carbon markets.

- **New standards are emerging all the time—it can be dangerous to be at the front of the pack:** The most obvious example of this has been in the voluntary carbon markets, where poor validation of credits has brought the entire market into disrepute. This has led to early adopters, who may have had very laudable intentions, being accused of greenwashing. In some circumstances, it might be prudent to wait for clarity from the various standards bodies in a particular area, while in other instances delay can result in accusations of foot-dragging. There is likewise the newly labeled phenomenon of "greenhushing," in which firms are reluctant to make, or talk about, their environmental commitments for fear of being pilloried or litigated against for inadequacy.

In such an environment, what does good governance look like?

To effectively manage this complexity, it is critical to think about how corporate practices and structures align, not just with disclosures (and ratings) but with desired outcomes (to join group 3 in the categorization above). One way to do this is to think more about the skills and processes required than about the formal structures to be established while paying attention to incentive structures and education/training. Below are characteristics of good governance and how these link to the ESG challenges of today, as well as new issues that will surely emerge.

Top-level direction: C-suite and the board

An enormous amount of attention has been paid to issues around board composition. Boards essentially need the right people with the right skills, behaviors, knowledge, and commitment to the job.[6] They also need to be complemented by an effective group of C-suite executives who share the same purpose and broad objectives for the company. If they are to be properly addressed, ESG issues must be mainstreamed and hardwired into a company's strategy, rather than sidelined or lodged with adjunct sustainability committees.

Capacity building to be able to evaluate ESG impacts

The new governance environment demands new skill sets. Bringing in new board or executive team members who understand the complexity of climate, for example, is important—but this is where the ratings vs outcomes issue can arise. "Checking the box" with a new hire is not sufficient if the issue is truly significant to the entire company; the entire leadership team must have at least a minimum level of understanding, so mandatory training may be required (given how hard it can be for seasoned corporate leaders to acknowledge gaps in their understanding).

As noted, the future is not the past, and different types of skills are required to effectively manage a shifting and unpredictable business environment. Most boards, for example, make use of some type of board capability matrix, but these tend to be heavily rooted in what people know and what experience they have had (legal, financial, marketing, strategy, audit, etc.). They often fail to include softer/newer skills such as systems thinking, the ability to work with uncertainty, and connectedness to different generations and broader stakeholders. At the same time, there may be a tendency to neglect political skills and understanding—yet these are crucial for most firms given the shifting regulatory and geopolitical environment.

Creating effective incentive structures: Linking pay to ESG outcomes

By 2021, 73% of S&P 500 companies were already tying executive compensation to some form of ESG performance (up from 66% in 2020), with the most oft-used metrics relating to diversity, equity, and inclusion goals (51% of S&P 500 companies used these in 2021, up from 35% in 2020). The share of S&P 500 companies that tied carbon footprint and emissions reduction goals to executive pay also grew considerably, from 10% in 2020 to 19% in 2021.[7] However, devising the right compensation and incentive structures is a challenge in itself, given how much harder it is to quantify desirable ESG outcomes than financial metrics and how different time frames affect the calculations (outcomes being evident only in the medium to long term while pay decisions are made annually).[8] One proposal is that companies should test out any ESG metrics for a couple of years before fully incorporating them into incentive structures, especially for broad groups of staff. But incentives will move the needle only if they are sufficiently stringent: A recent study by PwC and the London Business School found that European executives received climate-linked bonuses without making substantive climate progress, as bonuses were based on too lenient criteria.[9]

6 NB. The Norwegian sovereign wealth fund has called out the practice of "overboarding"—effectively holding too many board roles. This is a problem in terms of time availability and in terms of narrowing the group of people who are involved in corporate governance across an economy.

7 https://corpgov.law.harvard.edu/2022/11/27/linking-executive-compensation-to-esg-performance/

8 https://impactalpha.com/tying-fund-managers-compensation-to-impact-performance-is-easier-said-than-done/?mc_cid=0a8c308161&mc_eid=7f5b-fb1bed

9 European bosses hit easy targets for 'green' bonuses, pay report shows | Financial Times (ft.com)

Mainstreaming material financial ESG risks into financial analysis

Much of the regulation described above is designed specifically to ensure that investors can easily see how a company is performing on ESG criteria, so these can be factored into decision-making. The next step is to ensure that companies themselves fully align their ESG reporting with their financial reporting. The TCFD includes in its recommendations that: "preparers of climate-related financial disclosures provide such disclosures in their mainstream (i.e., public) annual financial filings."[10] Doing so requires far more attention to be paid to physical climate risk and resilience to such risk—and the same will be true of vulnerability to biodiversity risk as this becomes more prominent and TNFD recommendations are adopted. Both the TCFD and the soon-to-be-released ISSB sustainability standards recommend the use of scenario planning whereby a company's robustness to different climate scenarios is stress tested. This analysis should feed through directly to financial projections. As part of the solution in this area, there are serious efforts underway to establish a system of natural capital accounting for both governments and firms, including at the federal level in the US.[11]

Making sure systems track the right trends

As mentioned throughout this report, the challenges of good governance are continually evolving. Risks are neither static nor predictable, which is why it makes sense to show "foresight," establishing tracking systems to monitor trends and anticipate new requirements (and opportunities). Some new developments will be subtle, such as the potential for rivers and wetlands to be credited with "environmental personhood" and claim legal rights as such.[12] Others will be more obvious—for example, the shift toward biodiversity reporting (hence the early engagement of companies with foresight in the standard-setting process for biodiversity and their proactive approach to developing the capacity to monitor and report, having perhaps learned from their own sluggishness on climate change disclosure).

Similarly, many companies are rapidly awakening to their potential vulnerability to environmental litigation and finding ways to manage this. It will be important to create systems that can provide early warnings of vulnerabilities and feedback into the future design of corporate governance itself.

Looking around the corner

The above are clearly not the only governance concerns that will require attention. However, those noted serve as a starting point and an indication of the wide scope of issues—and rapidly shifting environment—that companies will face. The challenge will be to develop systems within this dynamic and complex environment that address the actual risks rather than simply address compliance. Ultimately, mitigating the myriad environmental and social risks requires a coordinated and integrated approach to ESG with clear goals and strong governance front and center. The process must be led from the top and supported by robust implementation. It must also be communicated in a transparent way both internally and externally to achieve the objectives that companies have set for themselves and that society demands of them.

10 https://assets.bbhub.io/company/sites/60/2021/10/FINAL-2017-TCFD-Report.pdf

11 https://www.whitehouse.gov/wp-content/uploads/2022/08/Natural-Capital-Accounting-Strategy.pdf

12 https://news.climate.columbia.edu/2021/04/22/rights-of-nature-lawsuits/

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