Board Governance Structures and ESG

Avenues Boards May Consider for Managing Expanding Responsibilities

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Companies are facing increasing pressure to manage a growing range of risks as a result of rapidly evolving environmental, social, and governance (ESG) issues. Climate-related factors have gained a great deal of attention among ESG matters, but the scope of ESG is much broader, including social aspects of a company's relationships with its stakeholders and a growing demand for effective governance and transparency.

As disruptive forces accelerate change and elevate expectations, many companies are facing challenges in protecting and promoting a sense of trust among their stakeholders, safeguarding their brands and reputations, and fostering business resilience. The increasing volume and complexity of challenges are causing an increase in the number and variety of issues landing on corporate board agendas.

How might boards adapt their governance structures to provide effective oversight in such a rapidly changing environmental and social landscape? What kinds of changes might boards make in the coming year?

KEY PROJECTIONS

ESG as a business driver. Geopolitical factors will remain prominent in ESG discussions in 2023, with a focus on climate change and decarbonization becoming increasingly front and center in political dialogue. The outcome of US midterm elections, for example, has shifted the balance of power in Congress in a way that could affect public policy, although the exact nature and significance of the effect is difficult to predict.

Despite shifts in the political environment, investor and corporate actions related to decarbonization and clean energy are not expected to change course, and the disruptive effects of these commitments and actions are expected to accelerate. One important reason for this expectation is the trajectory of change that is being driven by the financial services sector.

The Federal Reserve is expected to launch a pilot climate scenario analysis exercise with the six largest banks in the United States that is meant to improve measurement and management of climate-related financial risks, especially how climate-related financial risks may manifest and differ from historic experience. This initiative, among other factors, is expected to rapidly accelerate the role of financial services in driving an increased focus on climate-related financial risks.

Beyond financial services, corporate stakeholders such as vendors, credit raters, proxy advisory firms, and investors are increasing their calls for action. As an example, major credit rating agencies have developed methodologies for integrating ESG considerations into their credit analyses, and a credit trends report in 2022 indicated that ESG factors influence nearly one in four potential downgrades.

As another example, the Government Services Administration (GSA) has formed a panel to advise the GSA on driving regulatory, policy, and process changes required to increase climate and sustainability considerations within federal acquisition. Changes in procurement requirements are expected to unfold from this process for vendors that want to do business with the GSA, which says it oversees approximately $75 billion in annual contracts.

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ESG as a regulatory imperative. In the United States, the US Securities and Exchange Commission's (SEC's) proposals for new disclosure requirements on climate and cybersecurity are expected to drive new processes and controls for providing information to investors. While it is not yet clear whether regulations may be finalized or effective in 2023, the continued regulatory activity is expected to help accelerate focus and action regarding transparency and reliability of information that is provided to investors. The regulatory attention is also helping to drive greater focus on the quality and reliability of information that management depends on for making strategic decisions and developing targets and actions.

Beyond existing climate and cybersecurity proposals, the SEC is expected to take further action on issues such as human capital management and board diversity. An analysis of 2022 proxy proposals indicates Russell 3000 companies saw an increase in shareholder calls for action on human capital management, and a group of institutional investors is urging the SEC to require companies to provide more disclosure regarding the gender, race, and ethnicity of employees across job categories.

Regulations are also developing in many other countries, including the European Union's Sustainable Finance Disclosure Regulation and Corporate Sustainability Reporting Directive. In addition, multiple voluntary ESG reporting standards and frameworks are rapidly converging under the IFRS (International Financial Reporting Standards) Foundation to help shape the International Sustainability Standards Board.

Regulatory activity intensifies the need for companies to implement formalized governance structures and disciplined processes, which boards are required to oversee. At the board level, this is expected to drive a need for reconsideration of how risks are managed across board governance and committee structures:

- What risks/topics are on the board's agenda?
- Where does responsibility for each topic sit with respect to the board, committees, and management?

- What information on each risk or topic is presented to the full board or committee? In what form is the information presented, and how frequently is the topic being brought to a committee or the full board for discussion?

Possible adaptations. As a focus on ESG risks, opportunities, and performance intensifies across the marketplace, ESG is becoming increasingly integrated into the business and strategy, and this trend is expected to accelerate. Broadening the evaluation of materiality to consider the external impact on stakeholders as well as the changing environmental and market condition's impact on the company can be a helpful tool to balance stakeholder expectations. This is important for meeting increasing stakeholder expectations and strategic ambitions as well as for promoting resilience. Companies should consider defined, disciplined approaches using established infrastructure for determining climate-related objectives and targets, identifying and understanding risk considerations, performing scenario analysis to inform choices and risk responses, and determining reporting and monitoring activities.

At the core of integrating ESG into the business is governance, and governance begins with the board. Some corporate boards have adhered to a wait-and-see approach before taking action that multiple stakeholder groups are increasingly demanding, but the risk stemming from board inaction is escalating. Investors increasingly associate a lack of disclosure with the absence of any type of meaningful transition plan, and many investors are allocating capital accordingly.

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Based on original research into filings of S&P 500 companies dating back to 2012, it is evident that some boards are already making shifts. Data show that boards are expanding their committee structures in an effort to distribute board oversight responsibilities across committees in new ways. For example, the analysis finds nearly 80 different ways that companies have renamed or extended the name of their compensation committees, suggesting additional oversight responsibilities beyond the traditional remit of executive compensation. The pattern is similar for nominating and governance committees. As boards seek to address their expanding agendas within their governance structures, several shifts are possible:

- BOARDS AND COMMITTEES Boards may more intentionally consider each of their key enterprise risks within the broad category of evolving ESG topics and identify who owns each risk at the board and C-suite levels, including the full board or a board committee and which C-suite leaders. This shift could include consideration for whether the board needs to expand a committee's mandate or establish one or more new committees to effectively oversee a growing range and number of issues.

  As an example, human capital is an area commonly managed by a human resources process, but the issues associated with human capital management have evolved to present much more extended consequences for many companies in the current environment. As such, it is increasingly elevated to boardroom discussion.

  Boards may be considering questions such as whether human capital management should be overseen by the entire board or whether a board committee mandate should be expanded to include human capital, such as the compensation committee. Boards may also consider who in management is responsible for human capital and whether that function or person is sufficiently elevated in the organization to enable adequate interaction with the board.

As boards revisit how risks are overseen, it may be important to provide oversight that is holistic, or sufficiently distributed so that it does not become siloed either at the board or management level.

- **BOARD COMPOSITION** Boards may revisit their composition and consider whether they have an appropriate range of skills and experiences across existing members. This could include adding new members to further distribute the workloads, especially if the SEC requires disclosure regarding whether boards have experts on specific topics, such as cybersecurity or climate change. Boards may need to be thoughtful with this approach to guard against overreliance on subject-specific experts.
- **BOARD MEETINGS** Boards may consider ways to make their meeting time more efficient and effective. This could include revisiting the frequency and length of their meetings, perhaps with a mix of in-person and virtual meetings to increase meeting time without increasing travel time requirements.

  Boards may also increase their use of consent agendas for more routine matters that require less discussion, to make more time available for more challenging topics. Boards may work with management on presentation styles, asking for less focus on slides and more focus on dialogue, to allow more time in meetings for discussion.
- **INFORMATION AND REPORTING** Boards may also increase their expectations of management to provide more data. This could include elevated expectations for the types of data provided, data sources, and data quality. Some boards may increase their expectations of management to obtain independent assurance with respect to information that is shared publicly and relied on internally for strategic decisions and actions.

MAJOR BOARD IMPLICATIONS

ESG risk is business risk. It is evolving rapidly and increasingly rising to boardroom discussion because of its close tie to strategy, especially as stakeholder expectations evolve to become regulatory requirements.

Boards already have a responsibility to oversee strategy and enterprise risk management (ERM), and strategy and opportunity are tightly linked to enhanced ERM practices around climate and broader ESG risks. Boards may need to reconsider how their governance structures enable them to fulfill these critical oversight responsibilities.

Integration of ESG considerations across the enterprise, including at the board level, is important to enable companies to identify and respond to rapidly emerging and evolving risks. The scope of ESG is sufficiently broad that a siloed or bolted-on treatment of ESG as a stand-alone risk or initiative is rarely adequate to enable companies to achieve their missions or growth objectives in today's environment.

Boards have an important role in helping drive a culture that responds to the growing demand for action on ESG-related matters and embraces the evolving risk landscape in a way that identifies and seizes upon opportunities. Many companies may accelerate their adoption of processes or practices that increasingly integrate ESG into the business, such as with performance metrics or compensation incentives that help drive behavior.

Boards also have a unique opportunity to help increase confidence in their companies' sustainability journey and ESG-related data. Governance and transparency demonstrated through the use of rigorous processes and controls, including assurance, can help boards build trust with stakeholders across the enterprise.

BOARD OVERSIGHT QUESTIONS

1. To what extent is ESG integrated into business processes across the enterprise, and where could the company benefit from improved integration?
2. How does consideration for ESG risk align within the existing board governance structure?
3. How does the board's governance structure enable not only a comprehensive understanding of risk but also an ability to identify and act on opportunities that are emerging as a result of the growing focus on ESG?
4. What risks are most critical, and where does responsibility for each risk area sit within the board, its committees, and management? Building on an organization's materiality assessment (if available), how are ESG risks evaluated for integration into ERM?
5. Does the board need to shift responsibilities for oversight of these risk areas to provide proper coverage at the board level without creating gaps or silos?
6. Does the board need new committees or new members to effectively manage the scope of issues on the agenda?
7. Does the board need to reconsider the length, frequency, or format of meetings to manage its responsibilities effectively?
8. How can assurance of ESG data deliver trust in the marketplace and enhance the board's confidence as it relates to its sustainability efforts?

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