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# The Board and ESG

## What do ESG frameworks and investors expect?

**In this briefing note, we explore key expectations for boards of directors in relation to ESG issues as defined by leading ESG standards bodies and frameworks and the world's largest institutional investors. We find that all the leading ESG standards and frameworks reviewed have clear expectations for boards to oversee ESG issues, covering multiple dimensions of ESG governance best practice. We also find that the world's largest investors expect corporate boards to pay attention to ESG issues and many have issued board-specific guidance on ESG. Overall, we expect the role of the board in overseeing ESG to garner more attention going forward, especially given the increasing level of alignment in expectations for boards among standard-setters and investors.**

### ESG – A board issue…

Increasingly, boards are waking up to the importance of a corporate strategy for sustainability and acknowledging their role in addressing and overseeing sustainability issues within the company. In 2020, The Sustainability Board Report found that among the 100 largest public companies from the Fortune 2000, 63% now have sustainability board committees, representing a 17% increase since 2019.[i] Although only 48 of the 275 directors sitting on these sustainability committees had explicit sustainability credentials, expertise is rising and 33% more directors were found to have sustainability expertise compared to the previous year.[ii] A 2018 study by Ceres and KKS Advisors found that companies with strong board governance systems, including formal board mandates for sustainability, board expertise on sustainability and executive compensation linked to sustainability, are more likely to have established strong sustainability commitments and are better positioned to deliver sustainability performance.[iii]

### … that investors are demanding to be managed well

The largest global investors now expect board members to oversee ESG issues. A key reason why investors are asking boards to pay attention to ESG issues is that they are considered to be material financial risks that can have an impact on the bottom line.[iv] For example, a landmark study of 180 U.S. public companies found that high-sustainability companies outperformed low-sustainability companies over an eighteen-year period.[v] The value of improving ESG scores has been further recognized in research by Rockefeller Capital Management, which developed their own unique scoring system to rank a company's improvements in performance on material ESG issues relative to peers. The top improvers from this ranking were observed to outperform the Bloomberg US 3000 Index by 3% annualized since 2010.[vi] Academic and practitioner research has largely shown that ESG can help enhance returns. For instance, BlackRock states "A commonly held view is that a return sacrifice is needed when adopting sustainable investing. We disagree – and in fact believe the opposite is true."[vii]

### What do leading frameworks and standard-setting organizations expect from boards on ESG?

As the ESG field has matured, several key organizations have emerged to set standards and develop frameworks for companies to utilize. These organizations are highly influential as they help companies understand which ESG issues are material to performance and what kind of ESG metrics should be disclosed in company reports and factored into corporate strategy, as well as influencing overall market progress on ESG.

Given the increasing interest in board oversight of ESG, we have assessed five leading ESG frameworks/standards, reviewing their specific standards and reporting requirements. First, we sought to understand whether they specify a role for the board in overseeing ESG issues. Our results show that every major ESG framework or standard reviewed has outlined a role for the board in overseeing ESG.

Table 1: Sample of ESG Frameworks assessed for board oversight of ESG

| Framework or Standard | Primary Stakeholder | Year Founded | Market Adoption | Does the framework outline a role for the board in overseeing ESG? (Y/N) | Source of information relating to board oversight of ESG |
|---|---|---|---|---|---|
| Global Reporting Initiative (GRI) | Corporates and Investors | 1997 | 38,413 GRI Reports since established | Y | GRI 102 General Disclosures 2016 – Section 4 Governance |
| WEF/IBC[1] | Corporates, and Investors | 2020 | N/A (Recently launched) | Y | Measuring Stakeholder Capitalism White Paper – Pillar 1 Principles of Governance |
| Task force for Climate-Related Financial Disclosures (TCFD) | Corporates and Investors | 2015 | 785 organizations have committed to support TCFD | Y | Recommendations of the TCFD Disclosures - Governance |
| Principles for Responsible Investment (PRI) | Investors | 2006 | >3000 signatories | Y | PRI Reporting Framework 2020: Strategy and Governance |
| Sustainability Accounting Standards Board (SASB) | Corporates and Investors | 2011 | 403 companies report using SASB | Y | SASB Materiality Map: Leadership and Governance |

While each organization adopts a different approach, the role of the board is understood to be multidimensional, encompassing elements such as ESG oversight in committees, board composition and stakeholder engagement.

## Defining the role for the board

Next, to further understand each framework and their requirements, we analyzed each one against a set of eight different criteria that relate to the role of boards and how they can accomplish oversight of sustainability issues. Below, we present the high-level assessment of the board criteria, which shows the range of different board-level ESG indicators that are captured within leading standards and frameworks.

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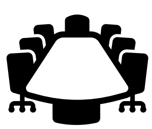
[1] Refers to a reporting framework launched in late 2020 by the World Economic Forum (WEF) and the forum's International Business Council (IBC), in partnership with the big four accounting firms: Deloitte, EY, KPMG and PwC.

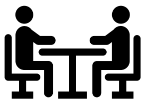
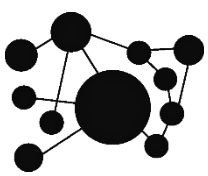
Table 2: Assessment of board criteria

| Framework or standard | Does the framework outline a role for the board? (Y/N) | Board Committees | Reporting Practice | Remuneration | Board Composition (Diversity & Ethnicity) | Board Composition (ESG Expertise) | Stakeholder Engagement | Risk Management | Material Issues | Total (/8) |
|---|---|---|---|---|---|---|---|---|---|---|
| **GRI** | **Y** | ✓ | ✓ | ✓ | | | ✓ | ✓ | ✓ | 6 |
| **WEF/IBC** | **Y** | | | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | 6 |
| **TCFD** | **Y** | ✓ | | | | | | ✓ | ✓ | 3 |
| **PRI** | **Y** | ✓ | | | | ✓ | | ✓ | ✓ | 4 |
| **SASB** | **Y** | | | | | | | | ✓ | 1 |

Below, we provide more detail on the indicators and examples of the expectations for boards.

Table 3: Indicators and Examples

| Indicators | Description and examples |
|---|---|
| <br>**Board Committee** | *Specific duties/responsibilities for board level committees on ESG are outlined.*<br>○ The GRI encourages organizations to report on which specific committee is responsible for decision making on environmental and social topics.<br>○ Contrastingly, the TCFD and the PRI framework (which is aligned with TCFD) encourage disclosure on the frequency with which committees are informed about climate-related issues. |
| <br>**Reporting Practice** | *The board is involved in the oversight of ESG disclosure on publicly available corporate reports.*<br>○ Only identified in the GRI framework, for which a formal review and approval of the board is recommended on an organization's sustainability report. |
| <br>**Remuneration** | *Remuneration is linked with the company's ESG-related objectives.*<br>○ Both the GRI and WEF/IBC framework recommend remuneration to be linked to an organization's economic, environmental and social targets.<br>○ Interestingly, the WEF/IBC framework references this disclosure as "an important advanced indicator of board quality."[viii] |
| <br>**Board Composition (Diversity & Ethnicity)** | *Boards consider diversity and ethnicity when appointing directors.*<br>○ Only identified in the WEF/IBC framework, for which quality of the governing body forms a key theme under governance, and here gender diversity and membership of under-represented social groups is addressed. |

| | |
|---|---|
| <br>**Board Composition (ESG Expertise)** | *Directors' expertise on ESG is disclosed or considered when appointing new directors.*<br>o The WEF/IBC framework focuses on the competency of board members on environmental and social topics.<br>o The PRI seeks disclosure on the level of experience board members have with incorporating ESG factors into investment decisions. |
| <br>**Stakeholder Engagement** | *Boards engage with their organization's stakeholders on ESG issues.*<br>o The GRI encourages disclosures on the processes of consultations between stakeholders and governance bodies on economic, environmental and social issues.<br>o The WEF/IBC framework includes a dimension of materiality for topics to engage on. |
| <br>**Risk Management** | *Boards take responsibility for oversight and management of ESG-related risks.*<br>o Second most prominent indicator across the assessed frameworks.<br>o The TCFD and the PRI (which is TCFD-aligned) recommend boards to consider climate-related risks when reviewing risk management.<br>o GRI promotes disclosure of the frequency with which environmental and social topics are reviewed by the board.<br>o The WEF/IBC encourages boards to be directly involved with management to integrate risk oversight. |
| <br>**Material Issues** | *ESG-related material issues are reviewed by the board.*<br>o Most prominent indicator across the assessed frameworks.<br>o The TCFD and PRI (TCFD-aligned) endorse board oversight on progress and targets for addressing climate-related issues.<br>o The GRI uses the sustainability report as a method to not only disclose on material topics, but also for boards to review and approve of these reports.<br>o WEF/IBC involves boards through the integration of material environmental and social issues in oversight.<br>o The SASB framework maps out materiality issues for different industries across a range of dimensions, which include Leadership & Governance, Environment and Social Capital. |

**Assessing the Expectations of Asset Managers for Boards on ESG**

The importance of board oversight on ESG can be further understood by looking at the expectations of leading asset managers. In an assessment of the top three asset managers in 2019 (by their global assets under management),[ix] we find that they outline clear expectations for boards to oversee ESG alongside promoting particular ESG frameworks for reporting purposes. The examples mentioned below outline the practices of the top three asset managers and their expectations for boards on ESG.

Table 4: Assessment of Expectations of Asset Managers

| Asset Manager | Assets under management (€ billion) | Does the asset manager expect boards to oversee ESG? (Y/N) | ESG Frameworks outlined in Investment Stewardship |
|---|---|---|---|
| BlackRock | 5,251.2 | **Y** | TCFD, SASB |
| Vanguard Asset Management | 4,257.2 | **Y** | TCFD, SASB |
| State Street Global Advisors | 2,196.8 | **Y** | TCFD, SASB |

BlackRock regularly publishes Investment Stewardship reports and insights to communicate their engagement practices and provide guidance to portfolio companies on what is expected from them. Through their Global Corporate Governance & Engagement Principles report, BlackRock lists out their expectations of boards. BlackRock expects boards of directors to promote and protect shareholder interests by addressing environmental and social issues, especially when they have the potential to materially impact company reputation and performance. In their Engagement Priorities for 2020 report, BlackRock states an expectation for companies to issue reports aligned with TCFD and SASB by the end of 2020. Furthermore, they state that they will hold directors accountable if there is not adequate progress on such disclosures.

BlackRock has also been advocating for a globally recognized framework to provide investors and other stakeholders a clearer picture on how companies are managing sustainability today and planning for the future. BlackRock have supported the International Financial Reporting Standards Foundation's (IFRS) proposal to establish a sustainability standards board that will work with existing initiatives to develop a global reporting system, and commented on the IFRS approach being "the most practicable and likely to succeed."[x]

*"We believe that when a company is not effectively addressing a material issue, its* ***directors should be held accountable****. We will generally engage directly with the board or management of a company when we identify issues. We may vote against the election of directors where we have concerns that a company might* ***not be dealing with E&S factors appropriately****."*[xi]

Vanguard publishes an annual report on Investment Stewardship that outlines how they engage with boards, for example on oversight of climate change or social issues. Here they encourage companies to align reporting with TCFD and highlight how they use SASB in their due-diligence process. Vanguard also publishes Investment Stewardship Insights, one of which focuses on Climate risk governance and further details the specific expectations from boards in governing climate-related risks. Boards are expected to oversee climate risks and be transparent about their decision-making process. To protect long-term investors from these risks, Vanguard urges boards to be competent, vigilant and transparent in the oversight and disclosure of climate-related risks.

*"Where climate issues are material to a company, we expect that the company has established* ***a climate-competent board*** *that can foster healthy debate on climate topics, challenge management assumptions, and make thoughtful and informed decisions regarding these risks."* [xii]

SSGA releases an annual Stewardship Report to engage with corporate directors, in which they document how material ESG concerns are incorporated into engagement efforts. In this report, SSGA recognizes how a greater number of companies are adopting the TCFD disclosures and see it as a standard overarching framework for climate risk. They also advise companies to seek guidance from the SASB framework in order to improve their

ESG disclosure. In 2019, SSGA launched their own ESG scoring system known as R-Factor™, to measure the performance of an organization's operations and governance towards financially material ESG challenges. In 2020, SSGA developed an ESG oversight framework for directors that requires the board to use their 'R-Factor™ Score' to then prioritize, periodically review and manage ESG performance.

*"We believe that a company's ESG score will ultimately become as important as their credit ratings for investment purposes… A company's ESG score will increasingly determine if trillions in global institutional and retail capital will flow toward them or away from them.* ***It is past time for boards to take notice****."* [xiii]

**Additional Case Studies of Asset Managers**

Upon further research of the world's largest asset managers, we identified additional case studies of managers, such as Legal & General Investment Management, UBS Asset Management and J.P Morgan Asset Management, which also outline expectations for boards to oversee ESG. Below we provide brief insights into what they expect from boards.

J.P Morgan Asset Management – *Rank: No.6, AUM (€ billion): 1,485.9*

- Provides a Governance Implementation Framework and ESG policy for guidance to boards on ESG.[xiv]
- Boards are required to adopt an annual governance calendar that explicitly includes ESG matters.[xv]
- Boards are required to provide oversight on progress and implementation of plans to navigate against risks and opportunities posed by climate change.[xvi]

Legal & General Investment Management (LGIM) – *Rank: No.12, AUM (€ billion): 1,131.2*

- Boards are given responsibility to ensure ESG data on reports is accessible and can be of use to any stakeholders who wish to access it.[xvii]
- LGIM recommends the use of integrated reporting for boards who wish to further demonstrate integrated thinking between ESG, financial and strategic information.[xviii]

UBS Asset Management – *Rank: No.22, AUM (€ billion): 681.7*

- UBS assesses companies on how boards oversee climate-related risks and opportunities and ESG integration in remuneration packages and board selection processes.[xix]
- New provision in the firm-wide proxy voting policy that, from 2020, allows them to vote against the board as a result of poor dialogue progress on climate change risks and opportunities.[xx]

**Why are leading asset managers promoting the adoption of SASB and TCFD?**

Among the top three asset managers, we see a clear trend of promoting SASB and TCFD. Below, we put a spotlight on these two frameworks to better understand the investor interest.

**SASB & Materiality**

In this study, we have identified four other frameworks that specifically require the board to oversee material environmental and social issues – and herein lies the importance of SASB. Boards that are attempting to address materiality in their organizations can incorporate the SASB framework as it specifically outlines financially material issues relevant to specific industries. SASB is designed to be useful to investors as it focuses on financial materiality. [xxi] Studies have shown that firms with good ratings on material sustainability issues outperform firms with poor ratings on the same issues.[xxii] A survey of 652 senior investment professionals found that 63% of respondents consider ESG information in their investment decisions because it is financially material to investment performance.[xxiii] In the US, the National Association of Corporate Directors (NACD) has encouraged directors to adopt the SASB framework as it can "help directors respond to an evolving set of risk oversight responsibilities."[xxiv]

While the SASB standards do not intend to capture traditional corporate governance issues, the standards have been under review and a closer alignment to the TCFD is expected in the future, meaning that SASB would align with the TCFD's governance recommendations. [xxv]

**TCFD & Convergence of Frameworks on Climate-Related Disclosures**

We are now observing a trend of standard-setters and framework developers increasing their collaboration and converging to provide organizations and stakeholders with more standardization.

In September 2020, several key organizations released a joint statement announcing a collaborative project towards comprehensive corporate reporting that can complement the financial generally accepted accounting principles (Financial GAAP). In this unique collaboration, the GRI, SASB, Carbon Disclosure Project (CDP) and the Climate Disclosure Standards Board (CDSB) set out the frameworks and standards for sustainability disclosure, with TCFD recommendations included for climate-related reporting. In setting out an aligned framework, expectations for boards to address ESG within their duties and responsibilities will become even clearer, with alignment on the 'Governance' pillar of the TCFD. [xxvi]

The TCFD considers the physical liability and transaction risks associated with climate change in order to provide the necessary information to investors, lenders, insurers and other stakeholders.[xxvii] The recommendations are set around four main themes that represent the core elements of how organizations operate: governance, strategy, risk management and metrics and targets. It is under the governance theme that the board's oversight of climate-related risks and opportunities is addressed as a recommended disclosure for organizations.[xxviii]

The TCFD framework has also been promoted by the NACD, which identifies the framework as providing "key components of climate-risk governance that boards can use." [xxix] The NACD also commends the TCFD disclosures and state that it provides "a great example of the growing integration that investors are looking for between corporate governance structures and disclosure on environmental and social issues such as climate change." [xxx] Below we outline some further examples of where TCFD disclosures have been adopted or promoted by other reporting frameworks:

1. In 2019, the PRI announced that TCFD-based reporting would be mandatory for signatories from 2020.
2. SASB and CDSB have worked together to release a 'TCFD Implementation Guide', which provides organizations with practical guidance on how to implement TCFD through SASB's and CDSB's frameworks.
3. CDP has released a guidance paper with CDSB to produce methods for effective TCFD-aligned disclosure using CDP data and the CDSB framework.

## References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