RISK OVERSIGHT IN THE AGE OF ESG – FURTHER CONSIDERATIONS FOR PUBLIC COMPANY BOARDS

Speaking at the 2021 National Conference of the Society for Corporate Governance, SEC Commissioner Allison Herren Lee noted that the days of treating what historically were called "corporate social responsibility" matters as separate from the operations and performance of a business are behind us. Commissioner Herren Lee went on to say that "[o]ur understanding of the significance of ESG and its short-, medium- and long-term relationship to financial performance has evolved to the point that the principal debates are about when, not if, these issues are material. Thus, … it is clear that the board has a role with respect to ESG." She noted that there is broad consensus regarding the physical and transition risks associated with climate change as well as significant and growing demand of investors and other stakeholders for climate and ESG disclosure. She concluded by noting that boards increasingly have oversight obligations related to climate and ESG risks.

There are myriad challenges to addressing climate and ESG risks. The risk landscape is evolving day-to-day, compounded by the shifting political, economic, legal, regulatory and technological contexts in which these risks are being assessed and pressure from a range of stakeholders. As part of risk oversight, it is important for boards to understand how climate and ESG risks can affect an enterprise and it is equally important for boards to view these risks, particularly in respect of climate change, not as ones crystallizing well into the future and, therefore, not material today. These are today's issues.

Let us start with defining the subject.

- At its core, ESG is about measuring progress towards sustainable goals. ESG is not an end in itself. It is a method by which asset owners, assets managers, other institutional investors, lenders, insurers, activist and other shareholders, other stakeholders, regulators and policymakers can assess where an enterprise stands on three continuums – environment (the E), social (the S) and governance (the G).
- ESG criteria have moved beyond corporate social responsibility and beyond the purview of the socially conscious. They are now mainstream and they should be viewed as key components of strategic direction.
- There is no universal definition of what comprises ESG or, more specifically, what criteria ESG should measure. Each enterprise will have its own ESG landscape based on a range of factors – line of business, global footprint and headquarters jurisdiction, exposure to supply chains, and so on. Unfortunately, today, those who measure ESG have multiple frameworks and metrics to contend with, and ESG does cover multiple vectors. This can complicate presenting an accurate picture of an enterprise, if, for example, the enterprise has attractive KPIs in the social realm, but poor scores on environmental impact.
- The ESG landscape is not, and is unlikely to become, static; it will continue to evolve.
- Ultimately, many frame ESG, in the context of businesses in a world where sustainability is viewed as a defining imperative, as a choice between long-term value creation and long-term value destruction. Note that many stakeholders have their own metrics to deal with – for example, not only what investors invest in but also how they manage their investments or, in the case of financial institutions, what operations they will lend to or insure.

ESG is about measuring, in respect of an enterprise:

- revenue opportunities versus challenges to future growth
- heightened costs versus cost reductions
- productivity enhancements versus productivity constraints
- optimized asset values versus asset impairment
- regulatory/governmental benefits versus regulatory constraints/intervention
- improved internal/external reputation versus stigma
- legal certainty versus legal liability

I list below a general set of ESG categories. Note that there will often be overlap. For example, climate vulnerability could have an impact on supply chains, responsible sourcing and community relations, as well as potential legal and/or regulatory issues.

"E": climate/environment	**"S": reputation/relationships**	**"G": internal governance**
GHG emissions/carbon footprint	Human rights	Board oversight of ESG matters
Biodiversity	Community relations	Business ethics/corporate culture
Climate change vulnerability	Labor relations	Enterprise risk management
Renewable energy	Employee/management diversity	Board diversity/composition/renewal
Energy efficiency	Employee health/safety	Shareholder rights
Air quality	Product quality and safety	Executive compensation
Water depletion	Customer privacy/data security	Crisis and risk management
Resource depletion	Pay equity	Stakeholder engagement
Pollution	Employee engagement	Disclosure practices/other communications
Ozone depletion	Child, slave and bonded labor	Responses to legal/regulatory landscape
Land use; changes in land use	Racial justice	Competitive behavior
Ocean acidification	Indigenous rights	Accounting
Use of raw materials	Supply chain management	Tax strategy/reporting/governance
Deforestation	Circular economy	Political contributions/lobbying
Waste management	Responsible sourcing	Anti-bribery/anti-corruption measures

In a report on board oversight of risk, CERES set out five key areas for boards to consider – identification, assessment, decision-making, oversight and disclosure of ESG-related risks, together with associated recommendations. These considerations all boil down to whether boards are prioritizing climate and ESG risks and are doing so in an effective manner.

As a threshold matter, it is important to recognize that there are different ways of thinking about ESG risk. From a climate perspective, one can start with the principal categories - physical risk and risk arising from the transition to a low-carbon economy. One can also focus on the impact of those risks on the enterprise, such as

- effects on operations (for example, effects of extreme weather events/sea-level rise);
- effects on financial performance (for example, direct costs of adaptation/mitigation or accounting charges (*e.g.*, for stranded assets));
- effects on supply chains;
- access to bank funding or the capital markets;
- availability of insurance coverage for the enterprise or for D&O insurance;
- effects on hiring and retention of talent ("human capital risk");
- exposure to regulatory constraints; and
- risks of legal liability.

There is also the overriding potential impact of reputational risk arising from the ways in which business are responding, or are seen to be responding, to the effects of climate change.

Similarly, the other elements of ESG, the S and the G have a range of associated risks, including the effects of a more pervasive focus by institutional investors and other shareholders on ESG metrics in evaluating the long-term attractiveness of their investee companies.

Finally, the other part of the equation must remain in focus as well – the opportunities.

Returning to the overall construct outlined by CERES, which is substantially similar to the World Economic Forum's effective climate governance principles (board accountability, command of the subject, structure, risk assessment, strategic integration, incentivization, and reporting and disclosure), albeit limited to climate, championed, for example, by the Climate Governance Initiative:

Risk Oversight Structure

- Define oversight at the board level.
  - How systematic is consideration of ESG issues at the board level? Are ESG issues regularly part of meeting agendas?
  - Which board committees have lead responsibility for ESG risk? In any event, what role does the audit committee play, given the intersection of ESG matters and external reporting?
  - How often does the full board consider ESG issues as part of the strategic planning process?
- Assess the background and expertise of directors to evaluate ESG risks.
  - Is the board sufficiently diverse (in the broadest sense) to understand and address sustainability priorities?
  - Does the board have among its members a sufficient number of directors with the expertise?
  - How is ESG incorporated into the nominations, training and evaluation processes?
- Ensure discussions of ESG risks/opportunities are coordinated across committees.
- Ensure that organizational silos at the enterprise level are minimized. This is likely an ongoing effort.

Identification of risks / opportunities

- Consider how ESG risks could affect the enterprise and its value creation.
  - What are the more significant risks?
  - How do the prioritized risks correlate?
  - When are the prioritized risks likely to manifest themselves? Understand that, in the case of climate risks, business disruptions can occur over cycles that transcend customary budgeting and reporting cycles. How material are the risks under different scenarios and time frames?
  - Which operations of the enterprise are most exposed to the prioritized risks?
  - How resilient is the enterprise?
- Determine whether existing internal processes are fit for purpose to identify ESG risks/opportunities.

- What is the process for tracking risks? Are risks being tracked internally as "climate/ESG" risks or are they evaluated as part of the broader risk landscape – for example, operational, regulatory compliance, supply chain?
- Which risks are in fact being tracked? How are they prioritized?

- Question what internal and external sources are used by management to identify ESG risks.
  - Are internal teams, including HR, IR, external reporting, sustainability and public affairs, fully aligned with one another?
  - Has management benchmarked the enterprise on ESG issues relative to peers?
  - What process has management put into place to determine what data are needed and from which internal or external sources?
  - To what extent do data reflect evolving risks and legal/regulatory and other relevant developments?
  - To what extent are data integrated into decision-making processes on an ongoing basis?
- Understand the assumptions embedded in the risk identification process.
- Assess the extent to which prioritized risks are integrated into the enterprise risk management process.
  - Are climate risks in particular viewed as such, or are they viewed as core to the business and operations of the enterprise?

Assessment of risk

- Reassess what information the board receives on prioritized risks.
  - Has management properly identified the correlations among the prioritized ESG risks and between those risks and the enterprise's strategy? Admittedly, there is little to no precedent, particularly for climate risk, for proper measurement, and as time elapses climate risk in particularly will likely worsen. There is also the potential for the correlations among ESG risks to exacerbate the overall risk landscape for the enterprise.
  - To what extent has management undertaken scenario analyses of the prioritized climate risks?
  - To what extent is there a focus on emerging climate standards to which the enterprise may become subject?
- Challenge management's conclusions on materiality.
  - To what extent might the correlation of ESG risks increase the materiality of individual prioritized risks?
- Ensure that prioritized ESG risks are raised at the appropriate board or committee meetings.
  - What triggers elevation of ESG matters to the board?

Decision-making in respect of prioritized risk / integration

- Consider how prioritized ESG risks affect strategy and how ESG considerations can best be integrated in the process of setting or evaluating corporate strategy.
  - What is the risk appetite?
  - Who at the management level owns each risk category?

    - Who ultimately is responsible at the management level for adaptation and mitigation?
- Understand what solutions are available to mitigate, or failing mitigation, adapt to ESG risks.
- Hold executives accountable for addressing ESG risks, and to do so means moving beyond short-term financial performance metrics. Boards should be mindful of the importance of integrating climate, other sustainability and broader ESG targets into management incentive arrangements. Boards should also consider whether existing compensation arrangements promote conduct that heightens ESG risks to the enterprise.
    - What ESG key performance indicators and targets are appropriate and are they embedded in compensation metrics?
    - How should performance against targets be measured and monitored given the long-tail nature of the risks and opportunities?
    - To what extent are compensation metrics aligned with corporate strategy?
    - Do plans tie compensation to internal metrics (such as investments in green technology) or external metrics (such as reductions in emissions)?
    - What is the most effective time frame for compensation metrics? In view of the long-term time horizons for climate mitigation efforts, should a standalone plan cover reduction of carbon emissions (where, for example, achievement of a specified reduction in carbon emissions is rewarded based on the speed of the reduction)?
    - Are all three of the GHG Protocol "scopes" covered by compensation targets? The more progressive plans would focus on Scope 3 improvements (*i.e.,* reductions by supply chain partners of their own emissions), as for many businesses, third-party ESG risk is significant.
    - How are data collected and evaluated for purposes of evaluating whether climate targets have been met?
    - From a compensation perspective, how are climate-related objectives tied into broader ESG goals?

Disclosure / Communications

For a range of market participants and other stakeholders, disclosure and its attendant transparency provides a wealth of information about the resilience of the enterprise. Disclosure is also about accountability – to prompt action and achieve sustainable outcomes.

Communications on climate-related issues can include both public disclosure (as in annual and other periodic reports, sustainability reports, analyst calls, earnings call and the like) or internal or other more-directed messaging:

Public:

- disclosure of how the board oversees ESG risks;
- disclosure of how climate and other ESG topics impact strategic decisions, perhaps as part of long-term corporate strategy or in a standalone sustainability report;
- risk factors;

- disclosure of the financial impact of climate change and transition/mitigation efforts; and
- disclosure against voluntary climate-related reporting benchmarks (for example, the recommendations of the Task Force on Climate-related Financial Disclosures, which cover governance, strategy, risk management and metrics/targets).

Less public:

- shareholder engagement efforts, particularly with institutional investors, which presumes too that the enterprise is forward-looking in anticipating shareholder expectations;
- internal communications to employees on values, priorities and vision; and
- communications with other stakeholders, such as suppliers, vendors, lenders, insurers and the markets.

In a sense, messaging and disclosure are the culmination of a range of board and management actions – from identification, assessment and decision-making, and governance and oversight, to the processes normally applied to shape and vet public company disclosures.

- Does disclosure cover physical risks *and* transition risks?
- How is scenario analysis addressed?
- Do the stated ESG ambitions of the enterprise match the enterprise's strategy and do they match corporate action across the board.

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As demands from the range of stakeholders referenced above for consistent, comparable and decision-useful communications on climate and other ESG topics continue to grow, and in light of the trend toward mandatory climate disclosure (but even in the absence of mandatory requirements), enterprises will need answers and those answers will need to be credible, fact-based and internally consistent. Stakeholders are looking not only for the messaging but also for quality data. For those answers to exist (and be properly communicated), the importance of board oversight will only increase.

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