***CUTTING THROUGH THE ESG NOISE*: A PRACTICAL FRAMEWORK FOR CORPORATE BOARDS**

Ana Dutra, *Experienced Corporate Board Director and Lecturer in Governance and Leadership*

Cigdem Oktem, *Regional Leader, EY Center for Board Matters*

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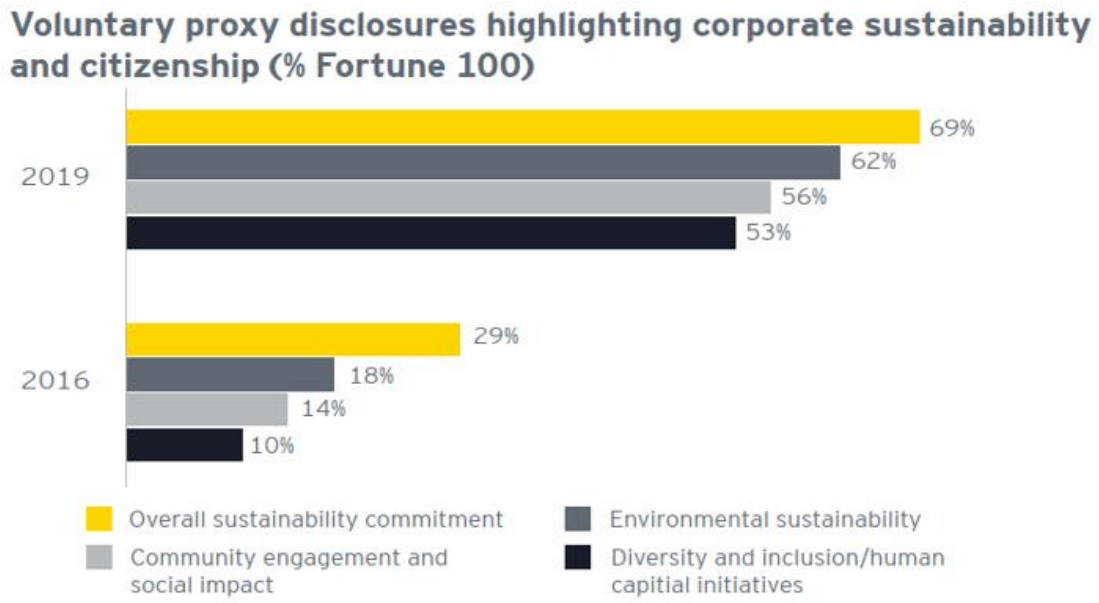
As we head into this proxy season, Environmental, Social and Governance (ESG) issues are achieving heightened awareness, judging by headlines of the past several weeks. Larry Fink's annual letter was quickly followed by various statements from Goldman Sachs, State Street, Fidelity, ISS and Glass Lewis about the importance of ESG considerations. With the recent plunge in economic indicators (not to mention markets) roiled by a potential pandemic, issues impacting company resources/supply chains and communities are likely to keep ESG dialed up in corporate conversations. While it is encouraging that the "triple bottom line" and ESG are becoming part of the dialog among investors, employees and other corporate stakeholders, there seems to be a fundamental lack of clarity generating an awful lot of noise along the way.

The Business Roundtable's statement last August signaled the shift many would say has been underway for some time - from exclusive focus on shareholders to a focus on main stakeholder groups with the recognition that corporations have environmental, social and governance impact and, therefore, responsibilities. According to the Global Sustainable Investment Alliance's 2018 Global Sustainable Investment Review, assets managed with sustainable investing strategies now represent 26% of all investment assets under professional management in the United States. A figure that is set to grow while boomers draw down their savings and millennials head into their peak investment cycle as the generation twice as likely as others to put their money into social or environmental investments, according to a 2017 Morgan Stanley survey. Indeed, a recent State Street survey of institutional investors found that 80% of millennials indicate ESG as a *component* of their investment strategies.

With all indications pointing toward ESG, not surprisingly boards and those who serve them are asking questions. Unfortunately, not only are the answers unclear, so are the questions. What exactly does ESG mean? What components, metrics and goals should management and boards pay attention to? How do these metrics truly affect corporate performance? Will the market, wall street analysts and other stakeholders truly reward companies and boards that are focusing on ESG issues? Finally, what are boards truly supposed to be doing about it? Recognizing the dilemma, our aim with this article is to acknowledge the complex, and at times conflicting, expectations and offer a practical approach to enable productive discussion between boards and their management teams. One that will also hopefully shape the external dialog with stakeholders.

More is just more when it comes to information

In trying to respond to investors and what they are being told investors are interested in, companies are taking on the mantle of reporting on ESG issues and providing voluntary, albeit somewhat vague disclosures. According to EY's Center for Board Matters, disclosures on ESG topics have more than doubled in the past few years, per the bar chart.



Source: EY Center for Board Matters, Five Takeaways From The 2019 Proxy Season

In 2019, 69% of the Fortune 100 stated their overall sustainability commitment and citizenship, more than double the rate in 2016. Specific examples involving environmental sustainability goals included emissions reductions, energy efficiency, recycling, water, etc. Charitable giving, community partnerships, employee volunteering, and programs to lower the cost of products and services to provide access were examples cited among the 56% disclosing community engagement and social impact (a sharp increase from 14% in 2016). Diversity & Inclusion/human capital initiatives disclosed more than quintupled and covered metrics such as pay equity progress, workforce training and development as well as diversity in workforce and hiring.

Beyond disclosures in proxies, companies are issuing sustainability reports at a rapid rate. According to the Governance & Accountability Institute, 86% of the S&P 500 have published sustainability reports (Flash Report, May 16, 2019). Typically, the reports are put together and handled by one of the operational departments, such as Environmental, Safety & Health (EHS) or a separate sustainability group entirely disconnected from planning or strategy.

However, quantity doesn't always mean quality. While there is ever more information being produced, that doesn't necessarily correlate to an increase in useful insight on value creation or translate into increased corporate performance or financial rewards – indeed, one could say (and many have) that the effect has been quite the opposite. In a recent survey of institutional investors , the Center for Board Matters found 85% pointed to the "lack of standardization/perceived gaps in company reporting [as] the biggest challenge in assessing how companies are managing environment and social risks and opportunities."

The information overload is likely to get worse before it gets better. Today, there is no shortage of initiatives inadvertently adding to the noise. These include: the Global Reporting Initiative (GRI), the International Integrated Reporting Committee (IIRC), the Task Force on Climate-Related Financial

Disclosures (TCFD), The World Economic Forum, and the Sustainability Accounting Standards Board (SASB). Below is a glimpse into how complex the choice of what to report can become.

FRAMEWORK NAME	Topic-specific disclosures or multi-topic?	Industry-specific or Industry-agnostic?	Standard or framework/ guidelines?	Primary Audience
Global Reporting Initiative (GRI)	Multiple standards across Economic, Environment and Social	Industry-agnostic	Standard	Multiple stakeholder groups
Integrated Reporting	Framework which covers all financial and non-financial issues	Industry-agnostic	Framework	Investors and multiple stakeholder groups
Sustainability Standards Board (SASB)	Multiple disclosures across Economic, Environment and Social	Selected industries	Standard	Regulators
International Standards Organisation (ISO)	Topic-specific standards such as GHG, Energy management or Social Procurement	Industry-agnostic	Standard	Multiple stakeholder groups
Sustainable Development Goals (SDGs)	The global goals cover all issues	Industry-agnostic	Guidelines	Multiple stakeholder groups
Principles of Responsible Investment (UNPRI)	Topic-specific questions within the questionnaire relating to investment impacts such as climate-related impacts	Financial sector	Framework	Investors
GRESB	Multiple indicators across Economic, Environment and Social	Real estate sector	Standard (Indices)	Investors
FTSE4Good	Multiple indicators across Economic, Environment and Social	Industry-agnostic	Standard (Indices)	Investors
Dow Jones Sustainability Index (DJSI)	Multiple indicators across Economic, Environment and Social	Industry-agnostic	Standard (Indices)	Investors
CDP	Specific coverage of climate change, supply chain, water and forests	Selected industries	Framework	Investors and customers
Task Force on Climate-related Financial	Climate change specific	Selected industries	Framework	Investors, lenders and insurers

Source: Carbon Intelligence, How to Choose the Best ESG Reporting Framework? August 2019.

While it is too early to say which framework or two will ultimately prevail, it is worth noting that 76% of institutional investors in the CBM survey pointed to SASB as a disclosure framework they would

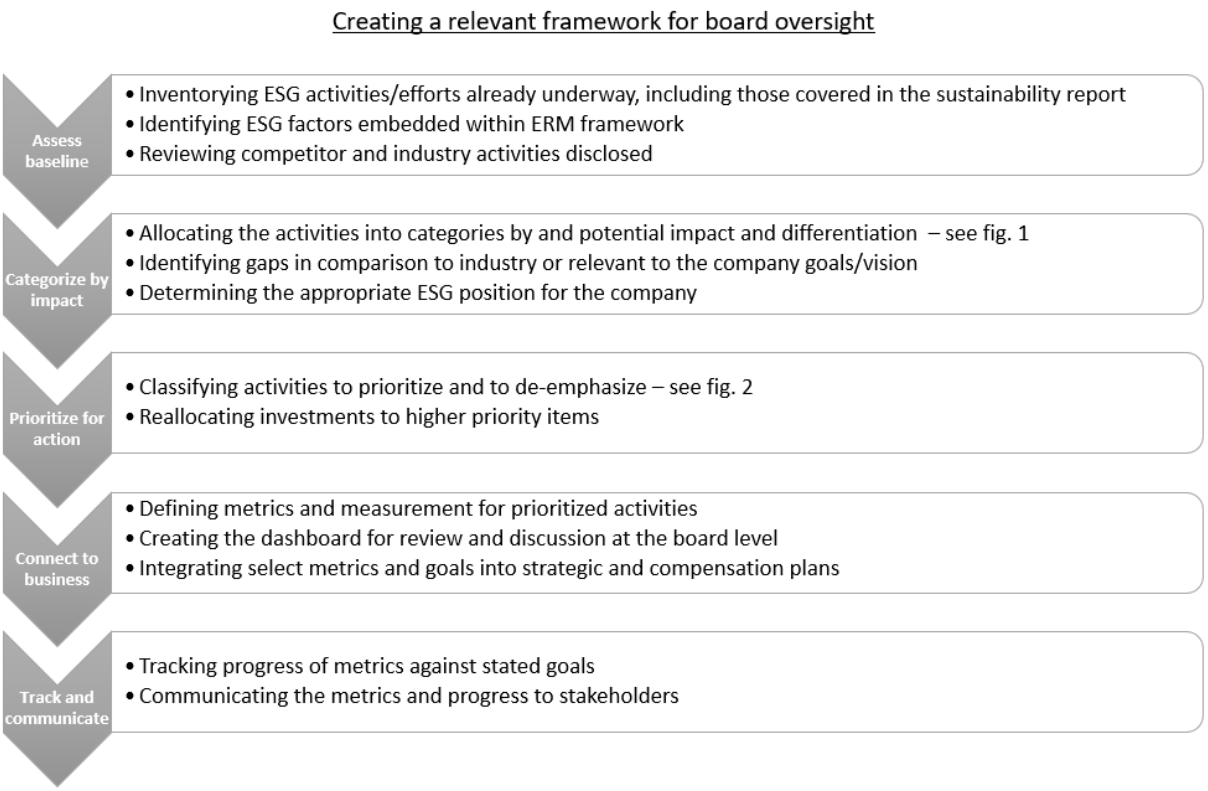
encourage companies to consider, something we have heard in discussions as well. Of course, since SASB by definition focuses on 'financially material' issues, directors are quick to point out the potential pitfalls.

Putting a board lens on ESG (connecting information to value to metrics and goals)

Earlier we referred to the State Street Capital survey of institutional investors that stated 80% say ESG is at least a component of their investment strategy. The punchline is that a mere 27% of investors -- institutional and otherwise -- actually integrate ESG criteria into long-term investment decision-making. ESG is in danger of becoming just another 'check the box' exercise where the clamor for information is met with routine reports.

Instead, there is a more worthwhile path to tread where boards can lead the way. If ESG is fundamentally about understanding key risks inherent in the environment in which a company operates – climate, geography, demographics, limited natural resources – and therefore needs to address in the interest of long term growth and value creation, why not treat the information with the same value lens as other critical information? The board looks at the big picture of the company today and in the future. There is a natural alignment to be had for ESG with strategy and all the risks and opportunities these entail at the board level.

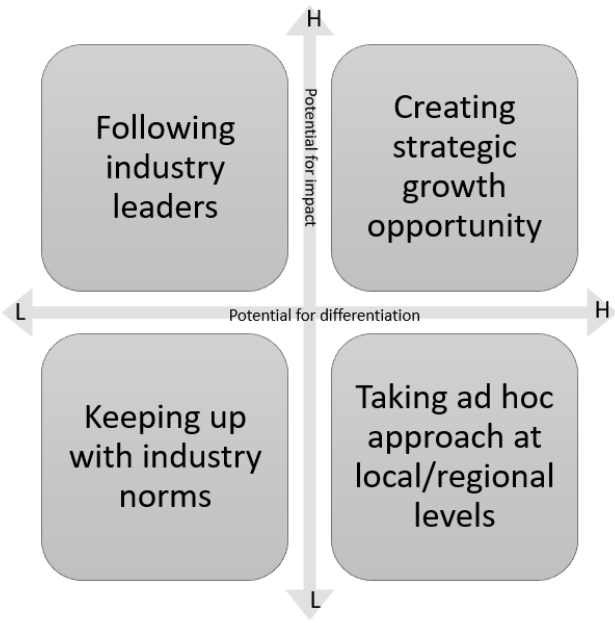
To ensure the conversation is at the appropriate level for the board, however, there is work to be done. Below is a framework we propose for this work.



Starting with an assessment or inventory of what activities under the ESG umbrella are already taking place and where. Are climate change and workforce risks showing up in ERM discussions? How are companies planning on responding and dealing with the Coronavirus threat by addressing employees, customers and suppliers' health, wellness and safety?

Is D&I an afterthought in HR or part of strategic workforce and succession planning? Once there is a good understanding of the current state of information, then these can be assigned to a strategic position matrix, such as the one below for example.

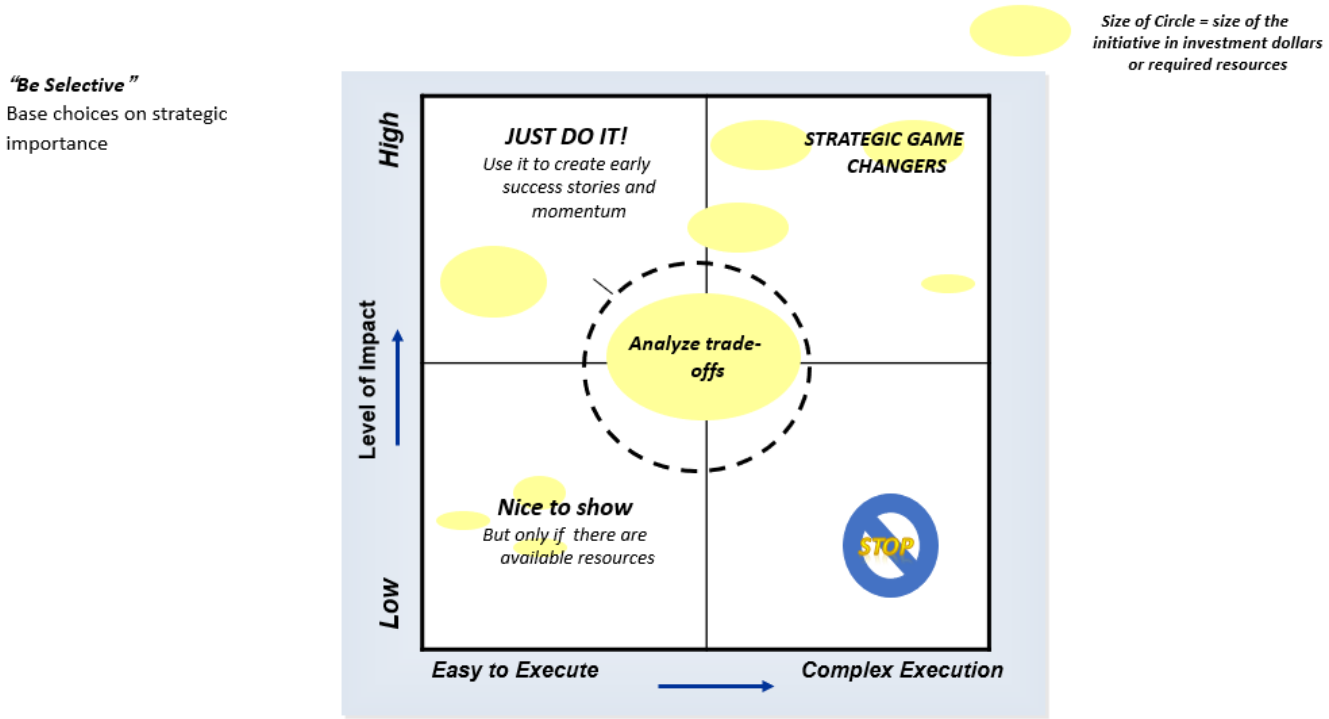
ESG Position Matrix (Figure 1)



Viewed through the criteria of potential for impact and potential for differentiation, the bottom left is where a company chooses to keep up with industry norms. This is akin to a 'defense' stance, essentially doing a minimum level identified. The top right represents more of the 'offense' zone where the playbook can identify a new need or a new way to monetize supply chain, etc. Following industry leaders can also represent an advancement on the path to creating that strategic growth opportunity. The bottom right represents those activities that are more likely to create differentiation at a local level rather than a company-wide impact, i.e. sponsoring local programs. Once leadership has arrayed the current efforts and decided where it makes the most sense for the company to 'play' in the ESG space, the next step is to prioritize what will be put on the shortlist.

As shown in the matrix in Figure 2, considering the complexity of execution along with impact helps to create a high-level roadmap for resource allocation - where to keep funding, start funding and stop funding ESG activities. How and when this gets on the board agenda will depend on the specifics of the board. Some may wish to see the broader list and provide guidance on what to winnow, in other cases the board may prefer a dashboard with just the shortlist of ESG related prioritized action items.

Prioritizing ESG Initiatives and Opportunities and Creating an Overall ESG Road Map (Figure 2)



The next steps are perhaps most critical – and most often absent – connection to the business, establishment of metrics and, finally, goal setting. If critical strategic ESG topics are being discussed at the board level, they are important to strategy and achieving future goals. In which case, the connection should be clear. And they should be integrated into strategic and compensation plans.

Lastly, tracking and communication. Tracking to understand progress against goals and where there may be issues arising that need to be addressed. Communication to help stakeholders understand what the leadership team sees as critical to risk management and success. Incidentally, this also addresses a common disconnect noted by directors who will say, "we are being told ESG is important, but when our CEO is doing a roadshow, no one is asking about ESG." If the factors are tied to what drives success, that becomes part of the conversation.

The importance of owning and communicating the company's ESG story

According to NACD's 2019-2020 Public Company Governance Survey, only 52% of boards reported in the last year they "improved the board's understanding of the company's current ESG-related performance." Even lower were those "reviewing ESG-related risks/opportunities" and "discussing the links between ESG and strategy."

As one director we interviewed summed it up, "In terms of Board of Directors agenda, ESG as an agenda topic is the equivalent to what CEO Succession was 15 years ago: either it wasn't in the agenda at all or was that last topic in the agenda which would quickly fall through the cracks if the meeting was running late or directors had to leave to get to their flights. In fact, key board discussion topics such as C-suite

succession, D&I and cybersecurity followed a similar path, from being absent to being key agenda items over the last 20 years"

With so much noise surrounding ESG, the strategic linkages and impact can easily get lost. Companies are in danger of ceding the telling of their story to others. In their 2017 ESG survey, the CFA Institute found that investors increasingly turn to public information and third-party research for ESG information on companies.

Why does it matter whether the company tells its ESG story in its own context? According to the ISS Early Review of 2019 Proxy Season, environment and social shareholder proposals outnumbered governance proposals, and nearly half of these E&S proposals received more than 30% support. More interestingly, nearly half of the submitted shareholder proposals (which were mostly on sustainability reporting and climate change), were withdrawn after some type of engagement between the proponent and the company took place. The implication is that companies can potentially avoid pitfalls by understanding their investors and being proactive.

As we enter proxy season, the top 3 investor engagement priorities for 2020 as told to the CBM team include: environmental issues/climate change (including the board's oversight of risk and opportunities, and enhanced disclosures), board diversity, and talent management. By articulating the specific metrics/activities in these areas and connecting them to the strategy and bottom line impact, companies can ensure the right conversations with their investors and stakeholders.

The bottom-line is that corporations have a priceless opportunity to shape the ESG narrative, taking the lead in a space that is important but still loosely defined. The alternative is to relinquish control of this same narrative to legislators, regulators, proxy advisory firms or activist shareholders. What will your board choose?

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Additional information:

Questions for boards to ask management in discussing ESG:

- How are our biggest shareholders considering ESG issues for our industry? What questions are they asking and who is asking them?
- What are our competitors disclosing and how (proxy, sustainability report, etc)?
- How are we currently identifying and disclosing ESG activities?
    - Do we have metrics and tracking against goals in place?
    - Do any executive compensation plans include our key ESG activities?
- How does our ERM and risk management framework reflect ESG issues?
- What is the appropriate prioritization in terms of ESG issues for our company?
    - Are there resource (natural, talent, financing) constraints that can derail our strategy?
- How do we define and think about our various stakeholders?
    - Note – directors are also having robust discussions amongst themselves about shareholders vs stakeholders, particularly in light of current legal standards
- Should executive compensation include identified high priority ESG metrics?
- How should we communicate any focus on ESG issues to shareholders and stakeholders?

Sample of Topics Covered Under ESG

Environmental	Social	Governance
Climate risk and mitigation	Diversity and inclusion	Board diversity, quality, effectiveness and accountability
Greenhouse gas emissions	Pay equity	Risk and opportunity management
Energy efficiency	Skills for the future	Capital allocation
Water consumption	Dignity and equality	Compensation policies
Pollution and waste	Human capital	Transparency in shareholder communications
Natural resource scarcity	Innovation of better products and services	Succession planning
Sustainable materials sourcing	Changing social views on data privacy	Shareholder rights
Clean energy and technologies	Health and well-being	
Product stewardship	Employment and wealth generation	
Biodiversity	Community impact	
	Ethical behavior	

Source: EY Center for Board Matters