ESG—The Role of the Board: A European Perspective

The heightened focus on environmental, social & governance (ESG) issues is presenting corporate boards in Europe with unprecedented challenges and opportunities. The question is no longer whether the board of directors has a role to play in a company's ESG agenda, but rather how best a board can utilize its decision-making, oversight, and advisory roles to build a more sustainable organization.

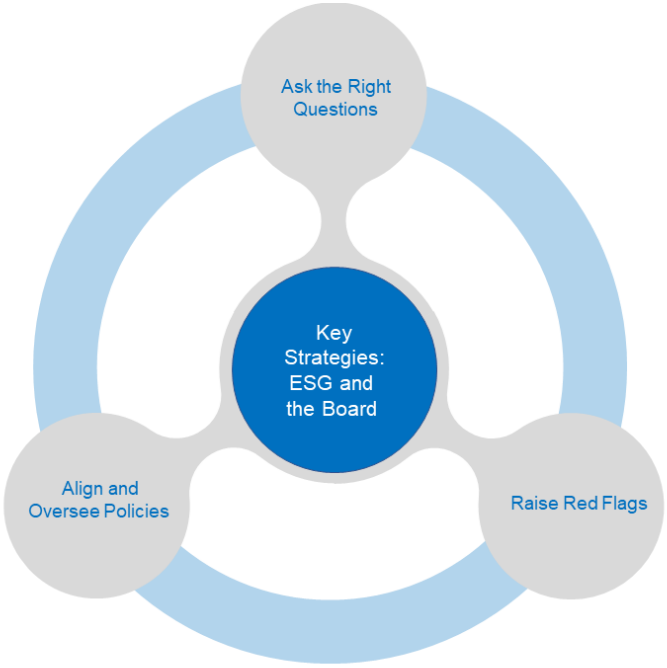
Insights for What's Ahead

- **Incorporating ESG and stakeholder perspectives into existing board processes involves mapping the board's current roles and responsibilities by taking inventory of the board's current approach to ESG issues and stakeholder views.**
- **Having specialist directors can be counterproductive if the rest of the board defers to them too much.** Directors who know the various roles of the board and have a deep understanding of their firm's industry will be better suited to ensure oversight of the company's key ESG risks and opportunities.
- **Several important actions must be taken in terms of allocating ESG responsibilities within the board.** These include addressing the full board's role with respect to ESG, allocating ESG responsibilities to several board committees to avoid overburdening one committee, assigning the responsibility for the coordination of ESG responsibilities to either the board or a board committee, keeping corporate governance documents updated, and discussing committee rotation and committee chair succession.

- **Management should set reasonable expectations on achieving board fluency in ESG.** With over 200 issues across the "E," "S," and "G" categories, boards cannot possibly address them all (nor should they).
- **There are three main filters that management can use when establishing ESG goals.** These are focus on areas strategically important to the company, establish the firm's degree, and assess the level of knowledge needed, depending on how far the company wants to go in its commitment to ESG. Among the issues that need to be addressed include compliance, risk reduction, reputation protection, and level of industry leadership. Management must appreciate that education takes time, and companies can expect ESG fluency to increase along with the maturity of the firm's ESG program.
- **Keeping the board informed on ESG requires a combination of direct board engagement and data.** Companies can enhance communication with the board and the board's engagement on ESG topics in various ways, including through the board's discussion of the company's purpose, the integration of ESG in strategic planning and operating/capital budget processes, and the incorporation of ESG in compliance and risk management discussions at the board level.
- **The company should also ensure that the board understands the breadth and depth of internal and external ESG-related communications, as well as the processes by which management seeks to ensure the accuracy and consistency of such communications.**

Driving the ESG agenda is not a series of distinct singular actions, but a fluid and continuous thought process.

Boards need to employ the following three key strategies in their ESG agenda:



1. Ask the right questions

Boards tend to get too little rather than too much information from management about ESG and stakeholder expectations. It is important that boards proactively ask their management for information including data, as well as an explanation of ESG approaches and actions, and stakeholders' expectations. Recent research demonstrates a disconnect between directors and their organizations in terms of environmental concerns. For example, a study published by Harvard Business Review in January 2022 found that while 72 percent of boards expected that their companies would reach their climate goals, 43 percent of these companies were yet to establish a carbon-reduction target.(1) This points to the information asymmetry between the board and management.

Additionally, directors need to stay updated on legal and policy developments in other countries, as many regulations have extraterritorial effects. For example, in May 2021, a court in the Netherlands ruled that Shell must reduce its carbon emissions by 45 percent by 2030. This was in effect a mandate to comply with the Paris Climate Agreement, and, as such, the rationale of the judgment is applicable to companies around the world.(2)

Boards must:

- Aim for ESG fluency and be informed about current events that may or may not be sector specific; and
- Based on available information, ask questions to better understand how the company will

deal with a specific issue. This is the backbone of a sturdy risk management exercise.

2. Raise red flags

A key duty of a board member is to be quick in identifying risks and raising red flags at the earliest opportunity in any given matter. Outside experts from diverse fields bring significant value and independent thought to the boardroom. However, this can be counterproductive if the board defers to them too much.(3) A survey published by Zurich American Insurance Group in 2022 found that only 25 percent of corporate directors said their board members can comprehend ESG risks well.(4) Risk identification is the first step in building a strong corporate risk management policy.(5)

Boards can play an effective role in ensuring that the company is prepared for risks and opportunities by:

- Identifying potential risks and bringing them to the attention of the management. Recent and ongoing lawsuits and class actions, regulatory policy documents, and geopolitical events are key sources for information on various kinds of risks; and
- Flagging of potential risks in a timely manner.

3. Align and oversee policies

Notwithstanding the board structure, whether it be unitary or dual, reviewing the company's internal policies is a facet of a director's fiduciary duty. Boards can be more effective by identifying aspects of company policies that need to be improved.

Increased focus on ESG issues has had a significant impact on boards today. This is because there is now greater external pressure on companies to address ESG issues, rather than to simply serve multiple stakeholders.(6) Institutional investors are playing a key role. For example, in 2022, 36 management proposals on climate were submitted to shareholder vote in European markets under review, as opposed to 19 in 2021.(7) The companies that proposed their climate strategies to shareholders were primarily from the energy, finance, industry, and services sectors. Similarly, annual general meetings for companies across eight European markets indicates growth in ESG resolutions,(8) which emphasizes the need for boards to keep up with ESG-related developments.

Boards have demonstrated an increasing focus on ESG policies in the US. A 2022 study by The Conference Board found that 72 percent of companies in the US believe ESG issues will have a significant and durable impact on boards over the next five years.(9)

European boards can take the cue from their global counterparts, and work towards embedding ESG awareness and targets in their company strategy by:

- Ensuring that the company is approaching ESG strategically, in keeping with building a sustainability culture; and
- Reviewing policies periodically to ensure that they are in line with ESG best practices and regulatory requirements, using peer networks and benchmarking tools if necessary.

Recent and Upcoming Regulations in the EU

Regulators are pushing for more ESG compliance—especially in the EU, which is at the forefront of the sustainability movement.(10) The following are examples of important recent and upcoming regulations relevant to ESG that boards need to be aware of.

- The **Corporate Sustainability Reporting Directive** entered into force in January 2023 and stipulates more detailed reporting set to commence in 2025. The directive requires large companies and listed small and medium-sized enterprises to report on sustainability matters such as environmental, social, and human rights; and governance. These companies will also be responsible for assessing information applicable to their subsidiaries. For non-European companies, the requirement to submit a sustainability report on ESG impact applies to all companies generating a net turnover of €150 million in the EU, and that have at least one subsidiary or branch in the EU exceeding certain thresholds.
- The proposed **Corporate Sustainability Due Diligence Directive**, once in effect, will require companies to conduct due diligence across their chain of activities. Such environmental and human rights due diligence will necessitate companies to review their internal policies; ensure that no adverse impact is caused to the stakeholders at large; and no “E,” “S,” or “G” rights are violated.
- The **Shareholder Rights Directive II** (SRD II), adopted in 2017, provides for ESG in company disclosures and increases transparency in non-financial metrics in remuneration plans. Legislative changes are bolstering expectations for companies to demonstrate that their executive pay practices are aligned with their company’s ESG performance and long-term value creation. Further, under SRD II shareholders in listed companies in the EU now have the right to vote on both the remuneration policy and the remuneration report, thereby increasing accountability for pay in European companies.

Corporations also need to consider the role of the board in defining the purpose of the company,

as purpose is why a company exists.(11) After identifying a purpose, companies can establish a strategy and allocate resources.(12) The board plays a crucial role in helping to develop a purpose. While purpose gives meaning to a company's existence, ESG practices—together with financial stability—ensure its sustainability. ESG analysis and compliance are effective tools for a corporate board to assess what is material while it builds a sustainability culture and strategy, and to safeguard it from various risks.(13)

Lastly, stakeholder capitalism—the idea that businesses serve the long-term welfare of all their constituents, not just shareholders—appears to be on a firm footing in many companies, with customers and employees ranking ahead of investors in stakeholder prioritization. By making ESG a priority, boards can send a strong signal to employees and other stakeholders that the company is committed to a purpose beyond profit.(14)

You can get a perspective on how ESG issues and long-term welfare of multiple stakeholders are affecting US corporate boards by reading *The Roles of the Board in the Era of ESG and Stakeholder Capitalism* .

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(3) Zurich American Insurance Company, *ESG and the New Mandate for Corporate Governance*, 2022.
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(6) The Conference Board ESG Center, Working Group Discussion, T*he Roles of the Board in the Era of ESG and Stakeholder Capitalism: Session One*, May 19, 2022.
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(9) Merel Spierings and Paul Washington, T*he Role of the CEO in Driving ESG*, The Conference Board, November
2022; see also: The Conference Board ESG Center, Working Group Discussion, T*he Roles of the Board in the Era of ESG and Stakeholder Capitalism: Session One,* May 19, 2022.
(10) The Conference Board ESG Center, Working Group Discussion, *The Roles of the Board in the Era of ESG and Stakeholder Capitalism: Session One*, May 19, 2022.
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(12) Robert G. Eccles, Mary Johnstone-Louis, Colin Mayer, and Judith C. Stroehle, *The Board's Role in Sustainability*, Harvard Business Review, 2020.
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(14) Thomas Singer, *Five Reasons Private Companies Care About ESG*, The Conference Board, 2022.

AUTHORS

Manali Paranjpe

Program Director, ESG Center, Europe
The Conference Board

Anuj Saush

ESG Center Leader, Europe
The Conference Board

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