Board ESG oversight: Embedding sustainability in corporate strategy

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Integrating environmental, social and governance (ESG) issues into a company's corporate strategy can help it identify growth opportunities and strengthen its risk management processes – and in doing that, we believe the potential exists to positively impact financial performance.

But to do this effectively, adequate corporate governance mechanisms need to be in place, and vitally, at the highest level of the company. Board directors must be capable of identifying ESG risks and opportunities and challenging management on sustainability issues.

Appropriate governance is key to ensuring sustainability is embedded in strategic decisions, both at board level, with the directors who set the overall corporate strategy, and among executive management tasked with the responsibility to implement it.

The key role of the board in the integration of ESG issues and the need for ESG oversight are both aspects that have been highlighted by a number of recent regulatory developments. In the US, the Security and Exchange Commission's (SEC) proposed rules on cybersecurity and climate change include requirements for companies to detail the processes through which boards provide oversight of these governance and environmental issues. [1]

In Europe, under the Corporate Sustainability Reporting Directive, companies will soon be required to disclose how sustainability issues are managed at board level, while the proposed Corporate Sustainability Due Diligence Directive, would clarify directors' duties by stating that "directors should take into account the short, medium and long-term consequences of their decisions for sustainability matters".[2] [3]

Our voting policy for company Annual General Meetings (AGMs) includes looking at the way the companies in which we invest are governed to ensure appropriate oversight of material ESG issues. From reviewing publicly disclosed information, we have identified the following main approaches chosen by companies to ensure the effectiveness of the Board oversight:

- Supervision of ESG-related issues falls within the prerogative of an existing non-ESG specific committee

[1] The SEC published its cybersecurity proposal on 9 March 2022 and its climate-related proposal on 21 March 2022

[2] The Corporate Sustainability Reporting Directive introduces mandatory reporting of non-financial performance for all European listed companies, starting from 2024

[3] The proposed Corporate Sustainability Due Diligence Directive would introduce a duty for large European companies to identify, end, prevent, mitigate and account for negative human rights and environmental impacts in the company's own operations, subsidiaries and value chains. The proposal has yet to be approved by the European Parliament and the Council.

- A standalone committee dedicated to ESG matters is implemented
- Or alternatively ESG oversight is the responsibility of the whole board.

In some cases, usually in smaller companies, ESG oversight is delegated to the top management, and falls under the responsibility of a chief sustainability officer, a dedicated executive committee, or the chief executive.

Oversight by a broader committee: The start of the ESG journey

One approach often seen at companies still in the process of integrating ESG issues into their board's agenda sees the remit of existing key board committees extended to include broader ESG-related responsibilities.

This could often be the Corporate Governance Committee, with sustainability-related responsibilities that may include overseeing corporate and social responsibility and initiatives. Another key committee often chosen to oversee ESG-related issues is the Audit and Risks Committee, with sustainability-related responsibilities that would mostly cover ESG reporting and identification of ESG-related risks.

However, we believe that this type of governance structure poses the risk that board supervision of ESG issues be limited to certain aspects of sustainability only. One recent study found that ESG scores for companies with combined committees were lower than for companies with below-board committees or a stand-alone board committee. [4]

Standalone ESG Committee: A strong commitment or a meaningless signal?

The idea that having a dedicated board-level ESG committee might be positively correlated to a company's ESG score has also been evidenced by academic literature. For example, studies have suggested that such a committee positively impacts the quality of ESG reporting[5] and is associated with higher ESG performance.[6]

With this type of governance structure, shareholders are provided with clear information to identify the directors responsible – and accountable – for the supervision of ESG issues, tasked with defined goals and duties. A standalone committee also gives shareholders comfort that sustainability issues are regularly discussed in the boardroom and acts as a signal to internal and external stakeholders of the board's and company's commitment to sustainability.

However, there is potentially a risk that having a specific committee dedicated to ESG could serve to isolate ESG-related issues from broader strategic discussions, and would therefore be counterproductive to fully integrating sustainability in the corporate strategy. In that regard, we

[4] NN Investment Partners, Glass Lewis: "*Exploring the links between ESG supervision and performance",* August 2021

[5] Azlan Amran et al: *The Influence of Governance Structure and Strategic Corporate Social Responsibility Toward Sustainability Reporting Quality*, June 2013

[6] Heiko Spitzeck: *The Development of Governance Structures for Corporate Responsibility*, August 2009

have also seen certain companies appointing a Lead Director dedicated to climate or broader ESG issues.

In the same way, this can signal the company's ESG commitment, put accountability for ESG oversight on a clearly identified director, and provide stakeholders with a dedicated board member to discuss and engage on specific ESG issues. However, having the responsibility of ESG oversight in the hands of a single director could again raise that problem ESG issues becoming isolated.

To prevent this risk, we consider it key for standalone committees to regularly report to the board, to ensure that ESG issues are fully grasped by all directors, meaning sustainability could be considered in every strategic decision. Similarly, the standalone committee needs to effectively coordinate with other key committees on specific ESG-related issues that may be relevant for the topics overseen by each of these committees.

Full board oversight: The holistic approach

A more integrated approach would tend to favour a governance structure where the entire board is responsible for ESG oversight, with ESG topics regularly on the agenda of board meetings.

However, considering the ever-increasing range of topics to be discussed and the limited number and duration of board meetings, this structure also poses the risk that ESG issues could potentially be overlooked. We believe the solution would be to ensure that sustainability matters are also fully incorporated on the agenda of all key board committees, depending on their specific responsibilities.

For example, an audit committee would oversee reviewing and updating the most material ESG risks as well as overseeing ESG-related reporting. A nomination committee would ensure that any gaps in sustainability skills are filled during the selection process of new board nominees, that regular training on relevant sustainability matters are provided to directors to maintain an up-to-date level of ESG expertise, and that induction of new board members covers the ESG issues most material to the company's business. A compensation committee would be tasked with the responsibility to link top management compensation with relevant ESG targets.

What is crucial is that both aspects of this structure work in tandem – the full board has overall responsibility for ESG oversight, but dedicated committees are also involved. Collaboration between these key committees is also necessary to ensure consistency in overseeing ESG issues, alongside reporting back to the full board, thus allowing for a more comprehensive, holistic oversight of ESG issues.

No 'one size fits all'

We do not insist there is a 'one-size-fits-all' approach to ESG oversight, as we believe company boards are best placed to determine which type of governance is best suited to them to ensure proper ESG oversight. The most appropriate approach can depend on various factors including the company's size, industry, materiality of ESG issues, and level of maturity of the sustainability strategy.

Regardless of the governance chosen, what always matters is the credibility of the company's commitment to its sustainability strategy. In that regard, we expect full transparency on the governance chosen to oversee ESG issues, as well as sufficient safeguards to ensure that the board is collectively able to account for sustainability matters when setting the corporate strategy, and challenge management on these issues.

Expectations for credible ESG governance

We expect boards to report on their ESG-related responsibilities and activities as seriously as they do their other functions – and this is set out in AXA IM's Corporate Governance and Voting Policy. Beyond detailing the governance in place to determine who bears the responsibility of ESG supervision, we also call on companies to be transparent when reporting on the related activities conducted by the board during the year, by disclosing key information such as the number of board and committee meetings dedicated to ESG, and the key sustainability decisions made during the year.

Credibility of the board's oversight is also dependent on a sufficient level of expertise in the sustainability matters that are the most material to the company's business. The results of a 2021 survey from PwC are therefore concerning – it found that only 25% of directors say their boards have a strong grasp of ESG risks. [7]

It is a positive development that board-level ESG skills have become more heavily scrutinised. For example, Climate Action 100+, an investor-led initiative aiming to ensure the largest corporate greenhouse gas emitters take action on climate change, has started collecting data to assess whether "the board has sufficient capabilities/competencies to assess and manage climate related risks and opportunities".[8]

Similarly, in the US, the Securities and Exchange Commission's (SEC) proposed rules on cybersecurity and climate-related disclosure could soon mandate companies to disclose whether their boards include cybersecurity and climate experts.

However, there is still some way to go; Climate Action 100+'s data is currently at 'beta' stage and being analysed internally only. Similarly, the SEC's rules have yet to be approved. In the meantime, there are still hurdles in terms of public disclosure to enable comprehensive understanding of board ESG expertise.

To overcome this, we push investee companies to include and disclose relevant sustainability skills in their board skills matrix. This should allow the Nomination Committee to identify any potential gaps in material ESG-related skills, and to ensure that these are filled. Moreover, we encourage companies to provide a qualitative assessment of the skills attributed to each director, enabling us to further comprehend the relevance of the director's experience.

[7] PwC's 2021 Annual Corporate Directors Survey, conducted among 851 US board members
[8] Climate Action 100+ Net Zero Company Benchmark

We also expect to see regular training on specific sustainability matters offered to board members, to keep their knowledge up to date. Having the chief sustainability officer invited to board and/or committee meetings to provide operational expertise on material ESG issues, and reaching out to external experts to provide guidance on ESG may also be useful way to enhance the board's ESG competence.

Meanwhile for executive management, challenging and meaningful ESG targets can be integrated into their compensation packages. We believe this is an important measure and at AXA IM we strongly encourage companies in which we invest to include material, credible, relevant ESG key performance indicators in their CEO pay.[9]

Our engagement approach to sustainability skills

We met with a European bank ahead of its 2022 AGM to discuss candidates for election to the board. We take seriously our voting responsibility and assess whether the board is appropriately skilled to address the strategic challenges facing the company.

This year, for the first time, the company started reporting on the level of its board's expertise in sustainability. Considering the materiality of climate change for the financial sector, and with no further information available, we conveyed our expectation that climate-related issues be clearly identified in the Board Skills Matrix and the directors' publicly available biographies, enabling us to ensure that the board is sufficiently equipped to set and monitor ambitious climate-related objectives.

The contribution of traditional governance aspects in effective ESG oversight

We strongly believe that other 'traditional' standards of corporate governance also play a key role in ensuring efficient board ESG oversight.

We believe that gender diversity on boards can help overcome the risk of 'group think' and trigger debate and innovation, something that applies as well to diversity in other areas such as age and race. [10] This can also lead to improving awareness around the materiality of ESG for the company's business.

The PwC Corporate Directors survey found that female directors are "much more concerned with climate crisis" (87% of female directors, versus 67% of male directors) and that female directors are "twice as likely to support mandatory ESG disclosure".[11]

[9] Learn more about AXA IM's approach to a meaningful integration of ESG metrics in executive pay here
[10] "*AXA IM to expand its gender diversity voting policy for both developed and emerging market economies*", July 2020
[11] PwC's 2021 Annual Corporate Directors Survey

The overall board composition may also affect the quality of ESG oversight. There needs to be a sufficient proportion of independent directors, to be able to challenge management on sustainability issues and ambitions. A diversity of expertise with the presence of industry experts could also help identify ESG risks and opportunities material to the company's operations.

Finally, sufficient ESG oversight cannot be achieved if board members do not dedicate enough time to these issues. We believe that it is key that directors remain available to adequately conduct their ever-increasing and growingly complex responsibilities as board members, and do not sit on too many boards.

We do not believe in a 'one-size-fits-all' approach to board ESG oversight and consider that the most appropriate approach depends on various factors including the company's industry and maturity of its sustainability strategy. However, regardless of the type of governance chosen, we expect the responsibility for ESG oversight to be clearly identified with sufficient time devoted to ESG-related discussions, along with an overall board composition in line with best standards. While governance of ESG within the board will likely evolve along with the development of the company's sustainability strategy, fully embedding sustainability in the corporate strategy may eventually require ESG to be incorporated in all areas of the board and key committees' work.

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