Directors Can Up Their Game on Environmental, Social, and Governance Issues

The BCG-INSEAD Board ESG Pulse Check

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The Corporate Governance Centre

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The Corporate Governance Centre

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The INSEAD Corporate Governance Centre (ICGC) is engaged in making a distinctive contribution to the knowledge and practice of corporate governance globally. Its vision is to be the leading center for research, innovation, and impact in the field. Through its educational portfolio and advocacy, the ICGC seeks to build greater trust within the public and stakeholder communities, so that businesses are a strong force for improvement, not only of economic markets but also for the global societal environment.

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The BCG-INSEAD Board ESG Pulse Check

If there was any doubt that we've entered a new era for corporate boards, the 2021 proxy voting season dispelled it.

Activist investors focused on accelerating Exxon Mobil's transition toward clean energy secured three seats on the oil and gas company's board. Meanwhile, Blackrock, the world's largest fund manager, voted against 255 directors during the 2020-2021 proxy year on the basis of climate-related concerns.

Such events are a sign of things to come—and are rapidly pushing environmental, social, and governance (ESG) issues higher on board agendas.

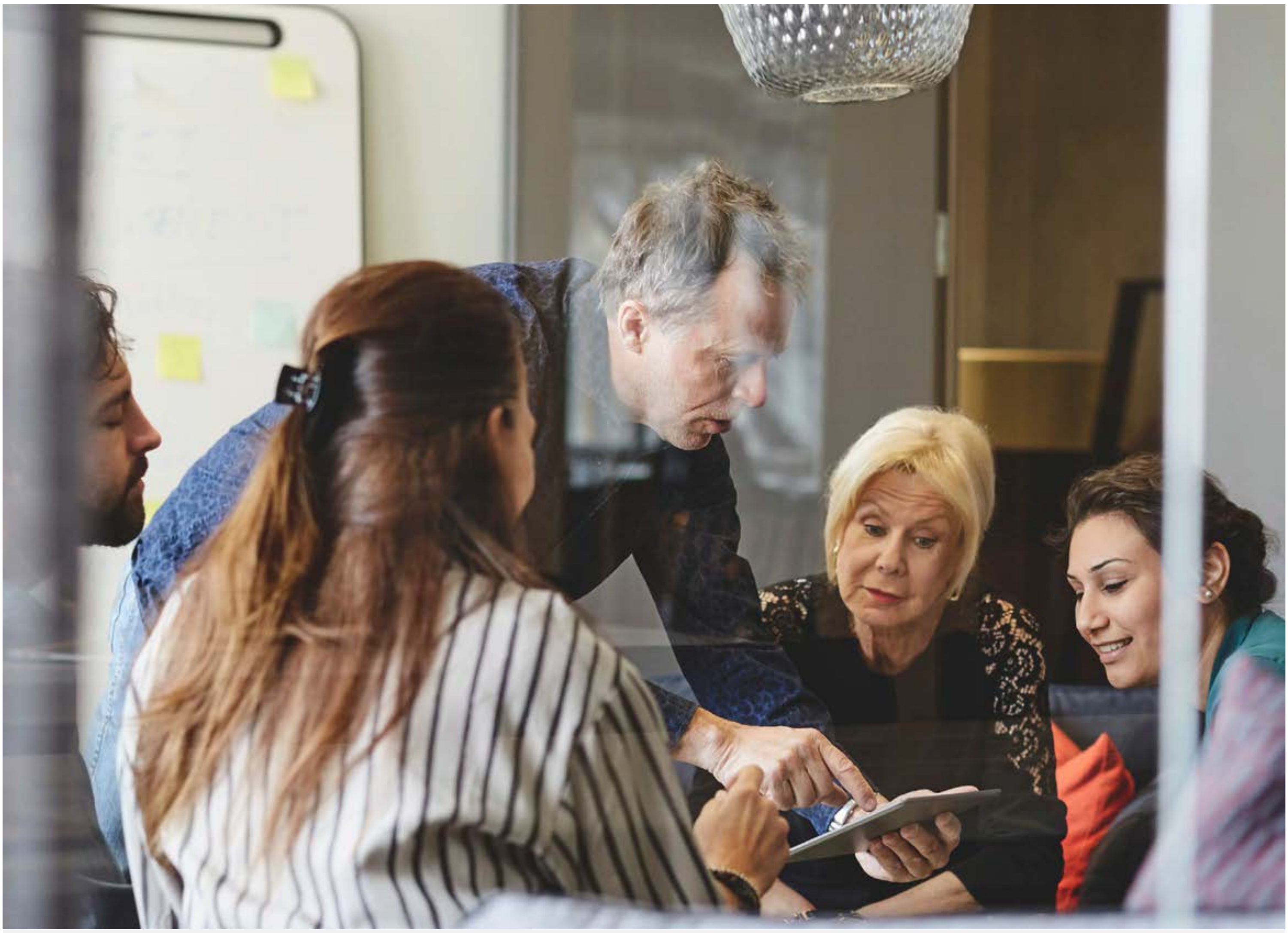
While corporate management is under constant pressure to deliver strong financial performance over the short and medium term, board members have a different time horizon; though directors certainly do focus on short- and medium-term performance, they play a critical role in steering companies over the long term. And the ESG challenges confronting companies today—including climate, income inequality, diversity, equity, and inclusion, and geopolitical tensions, most recently the war in Ukraine—will require sustained, long-term action. Consequently, such matters sit squarely in the purview of the board. "A company should not be taken by surprise on [the importance of] ESG," said one director serving on the boards of multiple energy companies. "Board members should be aware that it is now what society expects of you."

There is no one-size-fits-all solution for boards, however, when it comes to understanding, overseeing, and engaging with management on ESG issues. The topics that are material will vary by industry and are themselves dynamic by nature. And a board's actions will also depend in part on the company's maturity level with respect to ESG management.

With that in mind, BCG and the INSEAD Corporate Governance Centre have teamed up on a multiyear initiative, including regular pulse check surveys and interviews, to study the role boards play in overseeing ESG. We will assess how boards are engaging with ESG matters today and to what extent existing board practices can deal with these complex and systemic challenges. (See the sidebar, "The BCG-INSEAD Board ESG Pulse Check.") Additionally, in each survey we will take an in-depth look at a critical ESG matter facing boards; in this report we focus on climate.

Our goal in this collaboration is to help identify the most effective ways boards can integrate ESG considerations into their oversight and governance. This inaugural survey and interviews reveal a number of insights:

- Roughly 70% of directors reported that they are only moderately or not at all effective at integrating ESG into company strategy and governance.
- Although directors think their boards should devote more time to strategic reflection when it comes to ESG issues, more than half (53%) said they are not effective at doing that.
- Boards clearly see addressing climate change as a top priority; still, among companies with a net-zero commitment, only 55% of directors reported that their organization has prepared and published a plan for hitting that target.
- A full 43% of directors cited the ability of the company to execute as one of the biggest threats to delivering on ESG goals.



The BCG-INSEAD Board ESG Pulse Check

BCG and INSEAD bring complementary experience to the task of understanding the evolving role of boards. BCG has extensive experience working with companies in many industries to develop sustainability strategies and sustainable business models, as well as experience working directly with boards to integrate ESG into board oversight and governance. And INSEAD has in-depth academic knowledge on the role of boards in sustainability and long-term value creation, including the INSEAD Corporate Governance Centre's work leading academic studies and programs and the INSEAD Directors Network's applied, practical research leveraging the global community.

Through the multiyear BCG-INSEAD partnership, we will conduct a series of periodic surveys and interviews and draw on insights from our ongoing work as practitioners and academics. For this inaugural report, we have interviewed more than 50 directors who have at least 10 years' experience as a board member and who serve on more than 150 corporate boards combined. Our survey captured insights from 122 respondents who have an average of 7 years of experience as a board member and who are affiliated with 2 boards on average. The majority (80%) of respondents are non-executive directors, with 33% of those individuals serving as the board chair. Another 14% of respondents are CEOs and the remaining 6% support the board as corporate secretary and legal counsel. (See exhibit.)

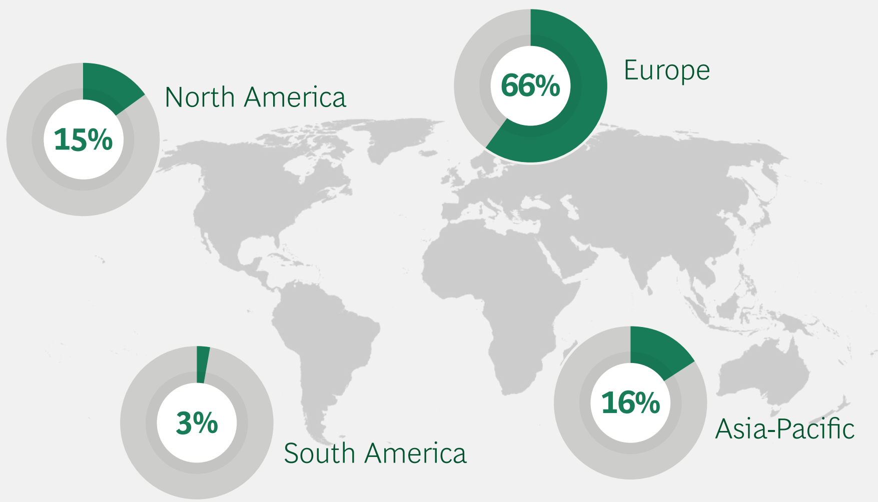
On the basis of this research and work, we aim to develop peer insights that help boards and board members become more effective at integrating ESG considerations into their oversight and governance.

A Breakdown of Survey Respondents

Industry

Industrial Goods	9%	Consumer Products	13%	Education	1%
Communication Services	3%	Energy	8%	Utilities	2%
Health Care	11%	Materials	11%	Real Estate	2%
Financial Institutions	24%	Information Technology	7%	Other	9%

Region



Designation

Chair	Director	CEO	Other
33%	47%	14%	6%

Organization Type

Publicly listed	Private equity owned	Privately owned	Other
47%	13%	23%	17%

Organization Revenues[1]

< $1 billion	$1 - $10 billion	> $10 billion
57%	25%	11%

Source: BCG-INSEAD ESG Pulse Check Survey (2021).

Note: the total number of respondents was 122.

[1]Revenues not provided by 7% of companies surveyed.

These findings highlight some critical gaps in board oversight of ESG. But they also reveal a major opportunity. Boards that rise to the ESG challenge can help the companies they oversee create sustainable competitive advantage while also driving progress on some of society's most significant challenges.

> **"A company should not be taken by surprise on [the importance of] ESG," said one director. "Board members should be aware that it is now what society expects of you."**

The ESG Imperative for Boards

Corporations are at the center of some critical societal and environmental challenges—and are often leading the way on solutions. This is reshaping board agendas and forcing directors to manage competing stakeholder interests. As our survey results indicate, however, many boards are still struggling with how to provide effective governance of ESG.

ESG Moves Higher on the Board Agenda. Powerful forces, including escalating investor and social activism, a mounting sense of urgency related to climate change, and increasing action by regulators (particularly on environmental topics), are changing the context for business globally. In this environment, more and more ESG issues are understood to create significant risks for companies as well as opportunities for building competitive advantage. Regulation in particular is an increasingly critical factor for boards when it comes to ESG, with the pace of regulatory activity picking up significantly in recent years. (See the sidebar, "The Regulatory Push for Sustainability.")

Boards, however, have historically not placed a major focus on assessing and governing ESG matters. There are two primary reasons for this. First, directors in the past have been guided by the view that their foremost responsibility was to shareholders—specifically, maximizing shareholder returns, with limited consideration given to the impact on society or the environment. Second, until relatively recently, performance in ESG was not widely accepted as contributing to financial performance.

However, today the thinking on both factors—fiduciary responsibility and the materiality of ESG—has evolved:

- **Fiduciary responsibility.** Businesses today are finding they are increasingly likely to be held responsible by shareholders and other stakeholders for the negative externalities they create in their operations, products, and services. Failure to address these issues will hinder a company's ability to create value over the long term. Given that reality, it is important to correct a common misunderstanding among many directors that the fiduciary duty of the board is to put shareholders first—especially short-term shareholders. In fact, corporate law in nearly every country in the world states that the fiduciary duty of the board is to the corporation. In that context, board members must be cognizant of sustainability issues that affect the company's ability to survive and thrive over the long term. This requires engagement by the company with shareholders, employees, customers, suppliers, and the communities in which the company operates. Importantly, shareholders are increasingly demanding engagement with the board of directors itself.

- **Materiality of ESG Issues.** A sustainability issue is "material" if it is important to stakeholders and related to creating long-term value. Some issues, like climate change, are material for virtually every industry in the world. Most, though, are very industry specific; safety in clinical trials, for instance, is material for a pharmaceutical company but not a bank. Analyses by BCG and others have shown that there is a correlation between company performance on material ESG issues and long-term financial performance. It's no surprise, then, that investors are increasingly integrating ESG into investment decisions.

"Business changes as society changes," noted one director who serves on the boards of multiple European financial institutions. "Formally the board role hasn't changed, but [boards] have more weight, and they cannot afford to jump into easy solutions when it comes to considering societal and environmental considerations as part of the long-term success of the company."

The Regulatory Push for Sustainability

Regulators around the world are increasingly using their authority to push for corporate attention and action on ESG issues. In Europe, where workers often have regulation-mandated representation on corporate boards, the interests of stakeholders such as employees have historically been factored into regulatory and corporate decisions more than in the US.

Nevertheless, the EU keeps pushing the needle. The European Green Deal, for example, aims to make Europe the first climate-neural continent; disclosure requirements regarding the social and environmental impacts of companies' activities are also being expanded. In addition, the EU is developing a sustainable corporate governance initiative to ensure that sustainability is further embedded into the corporate governance. The initiative ultimately aims to better align the long-term interests of business, society, and the environment, and to provide a framework for corporate boards to integrate these interests properly into strategies, decisions, and oversight.

At the same time, US regulators are also signaling a shift on how they view corporate responsibility as it relates to major societal challenges. For example, the Securities and Exchange Commission has issued new guidance regarding when companies can exclude a proposal from the company proxy statement. While the rule previously stated that companies could exclude a shareholder proposal if it did not raise social and ethical issues *for the company*—now companies must demonstrate that the proposal does not raise issues *with broad societal impact*.

A Delicate Balancing Act. As directors step up oversight and governance of ESG matters, they face demands from a wide range of stakeholders. Investors are taking a more activist stance: roughly three-quarters of our survey respondents reported that their board's dialogue with shareholders on ESG has intensified. And a similar share of respondents expects an increase in the number of shareholder proposals related to ESG issues. Some 64% of directors expect institutional investors to put forth new ESG-related proposals at their next annual general meeting; 33% expect pension funds to offer ESG proposals, and 30% of directors expect NGOs to do so.

Other stakeholders are becoming just as vocal. While three-quarters of respondents in our survey reported that shareholders are key drivers of company decisions related to ESG issues, a significant share also cited governments and regulators (62%), customers (55%), and employees (55%) as important players. Noted the director serving on the boards of multiple energy companies, "[boards] really need to engage with these [stakeholder] groups, showing that you take their point seriously and [demonstrating] commitment through monitoring and concrete plans."

> **There is no one-size-fits-all solution for boards when it comes to understanding, overseeing, and engaging with management on ESG.**

In some cases, various stakeholder groups may have differing priorities. Ultimately, it is the board's fiduciary role to put a governing mechanism in place that ensures the balancing of those competing interests. In that role, boards must challenge management on the rigor they have brought to determining which ESG issues are material. And they must bring similar robust oversight to how management is prioritizing responses to those material issues—and how management is linking its actions to the creation of business value. (It's worth noting that the view of which issues are in fact material can differ by region. Boards in Europe, for example, are more likely than boards in North America to factor in the interests of stakeholders other than investors—even if those interests tend to not be material in the strictest financial sense.)

For boards that lag in addressing ESG concerns, the risks for directors go beyond possible removal by activist shareholders. In many jurisdictions, board members can be sued based on what they did or did not do in relation to climate change, according to report by the Commonwealth Climate and Law Initiative; the potential legal liability stems from the fact that climate change poses a significant risk for businesses and therefore the board has a duty to address it effectively. This includes directors in the US, where the prevailing view has been that the interests of shareholders alone should take precedence. The first such litigation was recently filed—the nonprofit ClientEarth has initiated legal action against Shell's board of directors, contending they have failed to properly manage the company's climate risk.

Charting a Path Forward

As ESG issues become more central to the board agenda, it's critical to understand where directors see barriers to effective oversight and what practices they are putting in place to govern ESG.

Board Readiness

A key element of any board's role is to ensure the company delivers on its purpose and value statements. And about three-quarters of our survey respondents reported that ESG considerations are an integral part of such statements. However, a full 71% of directors said they are only moderately or not at all effective at governing ESG issues.

What accounts for that underperformance? We asked directors what roadblocks their boards faced when it came to addressing ESG-related matters. The top response: the board's lack of knowledge, data, and capabilities, a barrier cited by 44% of respondents. (See Exhibit 1.)

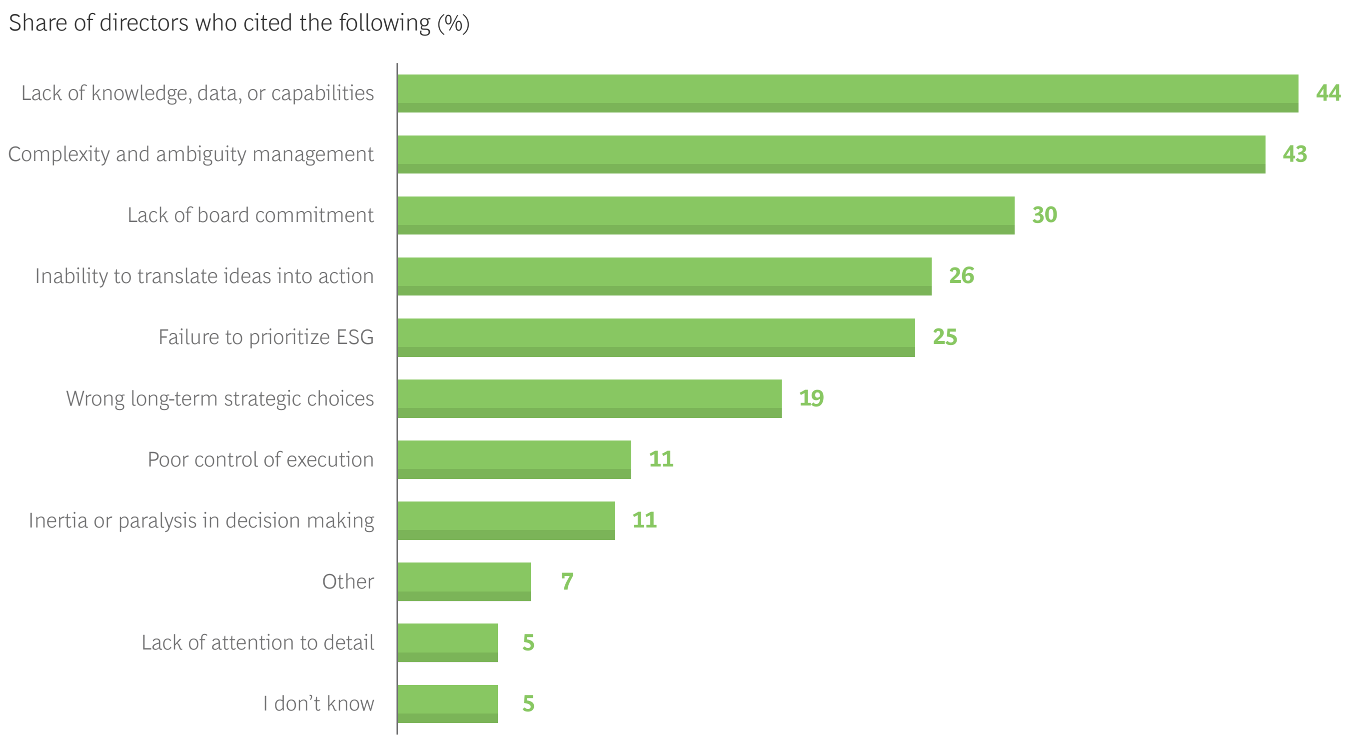
Assessing ESG factors to understand and identify those that are material today—or that are likely to become so in the future—and balancing stakeholder interests in a way that best guarantees the long-term success of the company isn't easy. It requires expertise that goes beyond the skills and competencies that have traditionally been deemed valuable for board membership.

Unfortunately, less than half of the directors surveyed—47%—believe their board has sufficient ESG competence and experience to challenge management on ESG plans and exercise board oversight on execution. That is likely due to the speed at which ESG has gained importance; boards, meanwhile, have not been aggressive about bolstering their ESG credentials. According to recent research by INSEAD and Heidrick and Struggles, 69% of respondents said ESG is not integrated into their board's competency matrix.

Directors also have concerns about how companies themselves are positioned to deliver improved ESG performance. The top barrier cited was the overall ability of the organization to execute (43%) followed by the potential for cost increases (35%). Organizational culture and management's commitment to addressing ESG concerns were also seen as major barriers by roughly 30% of those surveyed. (See Exhibit 2.)

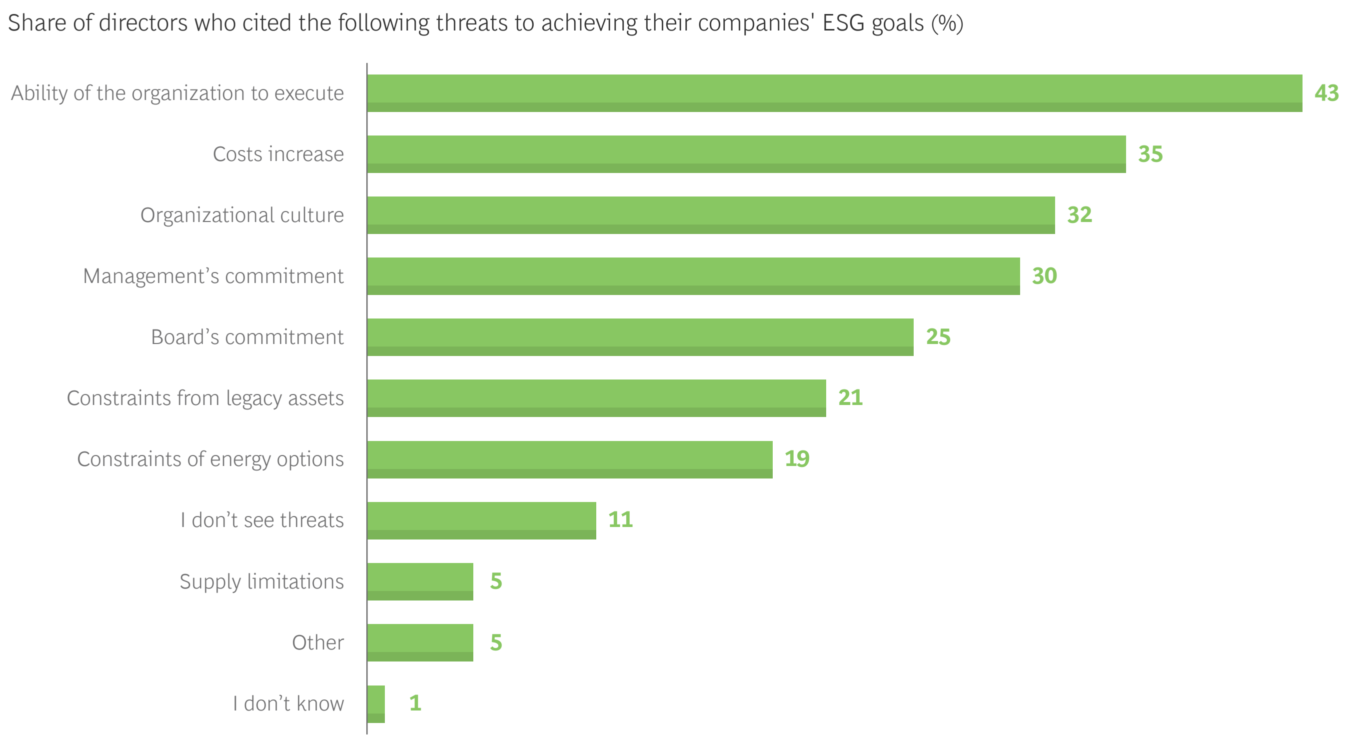
Even so, boards appear to be moving slowly to use levers such as compensation to incentivize a greater ESG focus: only half of those surveyed reported that ESG has been integrated into performance-driven compensation measures for management.

Exhibit 1 - The Roadblocks to Effective Board Oversight of ESG



Source: BCG-INSEAD ESG Pulse Check Survey (2021).

Exhibit 2 - Why Companies Aren't Fully Delivering on ESG



Source: BCG-INSEAD ESG Pulse Check Survey (2021).

Board Practices

To overcome these barriers, boards must reevaluate their approach to ESG governance, expand their access to knowledge and expertise on critical ESG matters, and rethink their agendas in order to devote more time to broad strategic reflection.

Board Approach to ESG Governance. Boards must make critical decisions about how to structure the ESG work and oversight they do. A recently released study by the INSEAD Corporate Governance Centre describes six core models for integrating ESG into board governance. The BCG-INSEAD survey revealed the extent to which companies are deploying these models. (See Exhibit 3.)

The most common approach (31%) for anchoring ESG into board governance is assigning oversight of these issues to the full board. In such cases, ESG issues can be discussed or worked on within committees, but the decisions related to these matters are made by the full board. Although this approach is prevalent, the risk is that ESG issues do not get sufficient time and attention given all the demands on the full board. The second most common structure (20%) is to have the issues governed by a dedicated ESG committee of the board, while the third most common approach (15%) is to have one member of the board—with no separate committee—lead on ESG issues.

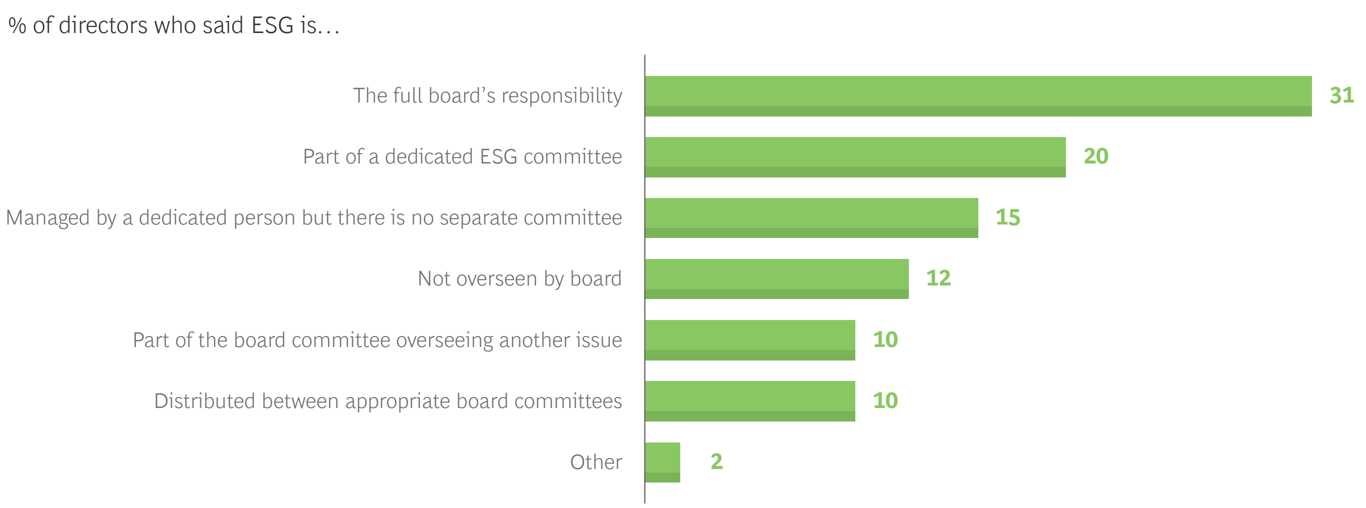
Looking at North America and Europe—the two regions with the largest numbers of respondents—there are some notable differences. In North America, ESG governance is three times more likely to be handled by an existing committee of the board than in Europe; meanwhile, in Europe these issues are two times more likely to be governed by a dedicated board member than in the US.

Ultimately, BCG's work with clients and INSEAD's research show that there is no single "best practice" for dealing with ESG issues. Companies are finding success—or challenges—with all models. The right structure will depend on factors such as the composition and ESG knowledge base of the board, its existing governance practices, the maturity of both the company and the board when it comes to addressing ESG topics, the experience and capabilities of the company's sustainability staff and resources, and the company's culture and history in integrating ESG into its business.

Board Knowledge. As noted above, directors see a lack of board ESG knowledge and competency as a meaningful challenge. Adding ESG education as part of regular board trainings can help establish a solid baseline of understanding among directors. However, boards should push for greater competency, systematically assessing what expertise they need in order to be effective at oversight of ESG issues. "Traditional knowledge and experience remain important," asserted one director who serves on the boards of multiple property and construction companies. "But one-third of the board should have knowledge and experience in how the role of business in society is changing and what that means for corporate strategy. This is essential to get sustainability embedded into board dynamics." While some boards may not follow this one-third rule to the letter, we do believe it is a useful guide when considering board composition.

Of course, the list of potential ESG topics is long and the materiality of such issues can change over time, making it impossible for boards to have experts on every relevant topic among their current directors. Consequently, boards must determine whether they need an expert on a specific ESG topic to be on the board—or should instead solve the knowledge gap by leveraging other experts.

Exhibit 3 - Models for Anchoring ESG in Board Governance Vary



Source: BCG-INSEAD ESG Pulse Check Survey (2021).

The ESG challenges confronting companies today will require sustained, long-term action.

There are advantages to ensuring one director (or even a few) has expertise on the most material ESG issues for the company. A knowledgeable director can influence the board's discussions and decisions to a greater degree than if they were an outsider. And having such expertise on the board shows the organization as well as external stakeholders that the company takes these topics seriously.

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Bringing in outside experts—whether on a regular or flexible basis—allows boards to focus only on finding advisors with deep subject-matter expertise on specific ESG topics rather than searching for someone who has both the knowledge of those specific topics and the broad experience that makes them suitable to serve as a director. Our survey found that the most common approaches to supplementing board knowledge are regular updates from an internal executive with responsibility for ESG (48%) and intermittent updates from external experts (40%). More permanent arrangements with outside advisors, such as implementing an independent advisory council with ESG experts, are much less common.

When it comes to drawing on external experts, different approaches will have unique advantages. One-off arrangements involving intermittent updates from external experts allow boards to access very specific expertise in a timely fashion—a critical advantage when materiality is in flux. The advantage of a more permanent arrangement with external advisors to the board is that they get to the know the company—and its challenges—on a deeper level, leading to richer discussions and arguably better decision making. Depending on the board's specific needs, the best approach may involve a combination of these measures and may change over time.

Board Agendas. The knowledge base of the board and the structure it creates to anchor ESG has direct bearing on a critical issue: giving directors the time for true strategic thinking. Our survey revealed that 91% of directors believe that when it comes to aligning the company's long-term business strategy with ESG challenges, the board should focus more on improving strategic reflection than on monitoring operations. However, less than half of that 91% believe they are effective at driving that strategic reflection. One director of a large global apparel company noted that, while the material provided to the board on which he serves is comprehensive, "there is rarely any discussion. It feels like a formality for the board, even though management does take the topic seriously."

The ESG issues that boards are prioritizing—and not prioritizing—today underscore the need for true strategic reflection. (See Exhibit 4.)

Few would dispute the importance of reducing carbon emissions. What is surprising, however, is the absence of some critical issues. Consider biodiversity, for example. The World Economic Forum's Global Risk Report, based on a survey of business, government, and civil society leaders, has identified biodiversity loss as one of the top five global risks in terms of both likelihood and impact. However, the issue does not appear to be registering among the universe of directors we surveyed. In general, such "multicriteria" ESG topics—those with multiple and interconnected drivers and significant measurement challenges—are not high on the agendas of many boards today.

So how do boards ensure they have insight on the forces—including those related to ESG—that will be shaping the world in the years and decades ahead? Scenario planning can be a powerful tool in gaining that requisite foresight, enabling the board to identify complex, long-term risks. "The primary task of the board is to look over the horizon," says the financial institutions director. "You need to understand where the world [is moving]." In addition to climate, robust scenario-planning exercises may include uncertainties related to geopolitical dynamics, technology development, inequality, and societal cohesion. However, roughly half of the directors surveyed reported their companies are not yet conducting such exercises.

Exhibit 4 - Carbon Emissions Are the Top ESG Concern

Top three ESG issues cited, by industry

	1	2	3
Consumer	Carbon emissions	Environment as a competitive advantage	Health and safety
Industrial Goods	Carbon emissions	Pollution and waste	Health and safety Climate change vulnerability
Energy	Carbon emissions	Public policy and regulation	Environment as a competitive advantage
Technology, Media, and Telecommunications	Cybersecurity	Carbon emissions	Business ethics
Financial Institutions	Cybersecurity	Climate change vulnerability	Financing environmental impact
Materials	Environment as a competitive advantage	Carbon emissions	Cybersecurity
Health Care	Employee engagement	Cybersecurity	Health and safety
Utilities	Carbon emissions	Cybersecurity	Board diversity

E S G

Source: BCG-INSEAD ESG Pulse Check Survey (2021).

The Climate Change Challenge

Companies are increasingly taking the lead on emissions reduction—and last year's United Nations Climate Change Conference (COP26) cast a light on that mounting sense of urgency. An unprecedented number of companies made net-zero commitments in the lead up to COP26, bringing the total to more than 5,200 at last count. Many of these companies are setting targets, developing clear pathways to reach those targets, and building the required coalitions. There are a growing number of private-public collaborations, including global initiatives to develop, scale, and deploy the technologies required to address hard-to-abate sectors. And action is being taken to ensure robust disclosure and reporting of private sector plans. As one director at a US auto manufacturer asserted, "Any board that has not grasped the climate emergency is no longer relevant."

Given the importance of the climate challenge, our survey included a deep dive on the topic to understand how directors are approaching the issue and where they could use more support.

Climate Rises to the Top of the Agenda. Some 42% of respondents reported that the companies for which they serve as directors have made net-zero pledges. As noted in Exhibit 4, climate is among the top three ESG issues in terms of expected financial impact for all industries except one (health care) and it holds the number one slot for consumer, industrial goods, energy, and utilities.

Yet despite the importance of climate, many companies have yet to offer a blueprint for driving progress on the issue. Among companies that have set a net-zero commitment, only 55% of directors reported that the company has prepared and published a plan for hitting that target. And an even smaller share—43%—said their company has published financial statements accounting for the implications of climate change.

More needs to be done. Certainly, committed investors understand that achieving net zero will not happen overnight and that companies need time to transition and develop truly innovative sustainable business models. In the near term, however, investors (and increasingly lenders) expect companies to publish a credible transition plan, along with clear targets and details on how the transition will impact the company financially. A company's transition plan must be robust and tested against a number of possible climate variables, including different levels of carbon pricing.

Companies that do not have clear plans—specifically, plans that are aligned with the goals outlined in the Paris Agreement—are likely to get pushback from shareholders. And even in cases where management and shareholders agree on a decarbonization plan, that may not be sufficient. Despite the fact that 89% of shareholders voted in favor of Shell's energy transition strategy for achieving net zero by 2050, for example, the Dutch arm of nonprofit Friends of the Earth successfully challenged the plan in court, arguing it was not in line with the Paris Agreement. More recently, the organization sent letters to 29 companies warning that they needed to disclose a carbon emissions reduction plan in line with the Paris accord or possibly face similar legal action.

The Role of the Board. As companies push to realize their net-zero ambitions, directors will play a pivotal role.

First, directors should ensure there is a clear transition plan, one that it is both ambitious and realistic in terms of the timeline. And they should facilitate communications with investors to ensure shareholders understand and support the plan, and, when possible, find ways to collaborate with investors to implement it. "If climate change is relevant to your business, we expect a strategy," says the chief investment officer of a large pension fund. "If we are confident that strategy is robust, we are allies and partners in this, both in asking for the regulatory support and in providing transition finance when needed."

Second, directors can also help management assess and address critical dependencies in the climate plan. For example, in some cases a company's net-zero pledge may hinge on expanding the consumer market for new, green products. And such market growth can, in turn, depend on the right government policy and regulation. Directors should motivate management to identify those factors that will impact the transition plan and determine which the company can influence and which are beyond its direct control.

Insight and understanding of these dependencies may lead boards to intensify their focus in certain areas. For example, boards will be increasingly assessing the role of their companies in driving collective action, including through alliances or industry initiatives. And directors will want to oversee company lobbying efforts more closely—both direct lobbying and activity conducted through industry associations. Directors should ensure that companies are lobbying for policies that support their decarbonization initiatives. And they should be particularly vigilant that the company is not publicly supporting green policies but privately lobbying to preserve the status quo.

5,200+

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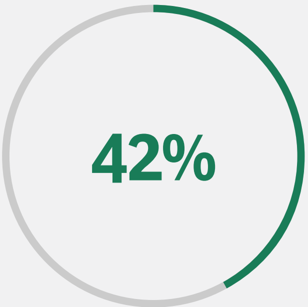

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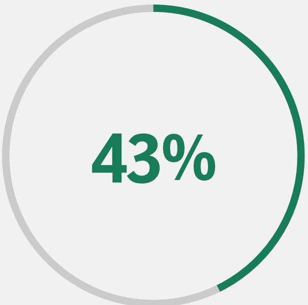

Among those same companies, only 43% of directors said their company has published financial statements accounting for the implications of climate change.

Boards that expand their focus on ESG can help the companies they oversee build sustained value creation.

The context in which business operates has fundamentally changed. Companies aiming to build lasting competitive advantage must transform their business for sustainability. For a board to steer a company effectively in this new era, it must master the material ESG issues that shape advantage in the company's industry.

As boards move to improve their oversight and governance of ESG matters, it will be critical to adopt an approach that is suited to a company's overall maturity level on ESG issues and the overall context in which the company operates. Directors can begin this process by answering some questions about the board's, as well as the company's, approach to ESG:

- Does the board regularly assess its composition, skills matrix, committee charters, use of experts, and cadence for effective ESG governance, informed by deep insight on ESG trends in the industry and among its stakeholders?

- Does the board integrate ESG fully into its corporate strategy discussions?

- Does it commit to an annual in-depth review of current and future materiality, company ESG performance, and targets?

- Does the board include ESG factors in enterprise risk management and risk tolerance discussions?

- Does the board consider ESG factors in all major capital allocation and investment decisions, business development, and innovation initiatives?

- Does the board make ESG explicit in business planning, target setting, performance assessment, compensation?

- Has the board approved a company statement of purpose and understood its link to the company's ESG agenda?

- Has the board approved an integrated report?

The answers to these questions can help directors understand where the board and the company stand in terms of ESG maturity and where they need to push for greater focus and action. Boards that expand and enhance their focus on ESG will be positioned to help the companies they oversee build sustainable business models—and sustained value creation.

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