PIRC

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BOARD GOVERNANCE AND OVERSIGHT FOR A **JUST TRANSITION**

CLIMATE GOVERNANCE

INTRODUCTION

The governance of responding to climate change is an increasingly important issue for both boards and investors. A gap currently exists between public messaging on how companies are addressing climate and social risk versus the skill-set and strategic understanding necessary to manage these risks. In 2021, the Stern Center for Sustainable Business found that, across all 1,188 board members on Fortune100 companies, just five and two board members respectively had relevant experience in the areas of climate and water[1].

Boards need independent non-executive directors with the competencies in order to assess the materiality of environmental and social issues affecting the business. Their role should in part be to question the extent to which companies are able to successfully traverse the transition to a low carbon economy, and even the future viability of the company.

During 2021 PIRC carried out a series of engagements to assess the extent to which current governance arrangements facilitate a meaningful response to mitigating climate-related risks. Initial research and engagement highlighted a number of climate governance issues including: a lack of related skills and experience, a lack of industry independence present on sustainability committees (or equivalent) and a lack of formal mechanisms though which relevant stakeholders (primarily employees) can play a role in shaping the decarbonisation strategy.

AUTHORS

Will Glover, Connor Constable, PIRC

BOARD SKILL & EXPERIENCE

As might well be expected, there is a lack of regulatory guidance available for companies when it comes to establishing or developing existing ESG competence at Board level. This is in contrast to guidance on the formation of an Audit committee which the FRC published in 2017.

A recent survey by PWC[2] also highlighted the need for more relevant ESG skills at Board level finding that only 30% of executives felt that their Board had 'good or excellent' ESG expertise, with only 27% of executives saying their Board is "sufficiently focused on climate change".

This research supports PIRC's own experience when discussing these issues with companies. Responses to questions relating to climate experience are often vague and boards typically cite experience garnered from roles at other companies, rather than specialist climate knowledge.

An example of good practice is highlighted in the Stern Centre's report with regards to Dow Chemicals, a company that had appointed candidates with appropriate experience to mitigate the specific environmental risks facing the company. Dow was considered by the centre to have three board members with relevant 'E' credentials: A member of the US Climate Action partnership, a former EPA Administrator and the Chair of the World Business Council for Sustainable Development.

During engagements on this issue PIRC has requested more granular reporting regarding Board competencies in relation to the governance of sustainability. Ensuring appropriate governance frameworks are in place is critical when assessing the capacity of company decision-making in relation to material climate-related risks.

POLICY RECOMMENDATION

→ Boards should disclose a skills matrix, detailing the skills and experience Board members have which demonstrate why they have been chosen to be on the ESG committee or equivalent.

→ In the case of the Chair of the committee, their understanding of implications from ESG/ Climate issues should be clearly laid out alongside their skills and experience.

INDEPENDENCE

It is a widely accepted principle of corporate governance best practice that maintaining a sufficient level of independence on the board is essential to ensuring a robust and effective decision-making process. Without diverse and independent representation on the Board acting as a counterweight to the executive element, companies' risk having the decision-making process dominated by individuals or small groups of directors.

It is equally important to assess the independence and effectiveness of Board's principal committees, not least those companies that operate a Board-level ESG or sustainability committee. Independence is important here not only with regards to the committee members relationship with the company but also with the sector in which the company operates.

As outlined above, companies often highlight an individual's experience within the industry as sufficient expertise to serve on a sustainability committee (or equivalent). Whilst a level of experience and understanding of how peers are addressing sustainability issues is of course important, industry experience can also have drawbacks. Not least, if a committee lacks members with independence from the sector itself, directors are less likely to challenge existing industry-based narratives or strategies that in turn facilitate a 'business as usual' approach. In carbon intensive sectors this often manifests itself as prioritising technological solutions to managing climate impact as opposed to opting for systemic changes to underlying business models. Sequentially, this risks eroding shareholder value as decisions in relation to capital allocation and expenditure targets are biased towards current business practices as opposed to pivoting to more sustainable revenues.

POLICY RECOMMENDATION

- Companies should be required to have a fully independent ESG committee (based on the relevant Corporate Governance Code requirements) as well as at least one subject matter expert with experience that extends beyond the immediate industry.

- If directors do not have sufficient climate expertise, the company should outline the training needed for them to have a sufficient level of understanding.

EMPLOYEE ENGAGEMENT

An important consideration for all businesses managing the transition is how to do so in a sustainable and inclusive manner. It is incumbent on all companies therefore to undertake informed and ongoing consultation with employees and relevant stakeholders, especially companies expected to undergo disruptive transformations.

Employee engagement models is an area PIRC has researched extensively during 2020 and 2021. Many companies in the UK have opted to designate a non-executive board member as responsible for engaging the workforce in order to comply with the latest iteration of the UK Corporate Governance Code. The expectation is for directors to understand and engage on significant issues facing the workforce, of which the energy transition ranks highly. Provisionally, the appointment of the designated NED (or in cases in which companies have opted for an alternative model a NED with relevant experience in employee engagement) to the ESG committee or equivalent could help ensure a company's transition pathway aligned with the needs the employee base. However, our preference remains for employees to have direct representation in governance.

The World Economic Forum (WEF) agrees with this approach as Principle 8 of their guiding climate governance principles[3] is focused around dialogue with stakeholders such as employees to "encourage the sharing of methodologies and to stay informed about the latest climate-relevant risks, regulatory requirements etc."

The notion of employees contributing to a company's decarbonisation strategy is encapsulated by the notion of the Just Transition. As outlined by Anabella Rosemberg as far back as 2010[4], climate change is having and has had huge impacts on employment across the globe and it is vital for companies to offer support and assurances to workers affected by them. With employee engagement and support such a key part of the Just Transition, it should be considered throughout a company's climate strategy and risk management, including formation of appropriate internal governance frameworks

POLICY RECOMMENDATION

→ Boards should have employee or union representation on the ESG committee, preferably through employee directors or equivalents. Where companies have adopted the Designated NED or equivalent model, these directors should serve on the committee.

→ Annual reports should provide information on how employee views have been considered in relation to transition risk.

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Pensions & Investment Research Consultants Limited
Exchange Tower
2 Harbour Exchange Square
London E14 9GE
Telephone +44 (0)207 247 2323
Email info@pirc.co.uk
www.pirc.co.uk

PIRC

RESEARCH
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