Running the Risk: How Corporate Boards Can Oversee Environmental, Social and Governance Issues
(Ceres, December 2019)

Objective: To provide guidance to corporate boards on how they can effectively oversee risks posed by ESG issues, including questions for directors to ask management throughout the risk identification, prioritization and mitigation processes.

Background:
- ESG issues such as climate change, water scarcity and human rights abuses can affect corporate strategy, business objectives and performance over both the short and long-term.
- There are seven risk categories considered in this report:
  1. Physical: In 2017, 73 companies on the S&P 500 publicly disclosed a material effect on earnings from weather events, and over 90% of these companies disclosed the effect on earnings was negative.
  2. Supply chain: Supply-chain disruptions due to climate risk have increased 29% from 2012 to 2019.
  3. Reputational: 47% of consumers walk away from a brand that doesn’t align with their beliefs.
  4. Regulatory: The number of climate change regulations has grown to 1,500 globally, up from 72 in 1997.
  5. Litigation: More than 1,000 cases have been filed in the U.S. on climate change impacts as of May 2019.
  6. Transition: Electric vehicles (EVs) are on track to account for over half of new car sales by 2040.
  7. Human capital: 86% of millennials would consider taking a pay cut to work at a company whose mission aligns with their values and the cost of replacing one employee is between 10-30% of an employee’s annual salary.
- According to the World Economic Forum’s 2019 annual global risks report, “Of all the risks, it is in relation to the environment that the world is most clearly sleepwalking into a catastrophe.”
- Risks are already being felt today, for example:
  - The Wall Street Journal called PG&E’s 2019 bankruptcy following the devastation of the 2018 Camp Fire in California “the first climate-change bankruptcy,” and noted that uncertain climate change risks will cause significant disruptions across industries.
- ESG issues have financial impacts, for example:
  - Companies that have more diverse management teams have 19% higher innovation revenue and report better overall financial performance.
- Investors are driving action on ESG risks by:
  - Calling on their portfolio companies to demonstrate progress on relevant ESG topics.
  - Significantly stepping up their engagement with companies exposed to ESG risks.
    - In 2018, over 300 global investors with more than $33 trillion AUM formed the CA100+ initiative to engage 161 GHG emissions-intensive companies on climate risks.
  - Calling for greater disclosure of ESG risks to better assess impacts to their portfolios.
  - Calling on boards to oversee business-relevant ESG issues.
A survey of institutional investors reported that their top three engagement priorities in 2019 included board oversight of ESG issues—particularly climate risk.

- Boards have oversight responsibilities that apply to ESG risks because they are stewards of long-term corporate performance, and it is the director's job to exercise risk-related oversight.
- Generally, directors are not currently prioritizing ESG risks.
  - Only 6% of U.S. corporate directors surveyed selected climate change as a focus area in the coming 12 months.
- Risk management standards are evolving to include oversight of environmental and social factors.

**Findings:**

Below are recommendations for boards as well as questions that directors should ask throughout several steps in the process of board oversight of ESG issues:

**Risk identification:** The board has ultimate responsibility for overseeing a company's risk management process. Here are several recommendations for boards, including questions directors should ask:

1. Consider how ESG risks could affect your company.
   - What kind of risks could ESG issues pose to the company?
     - Historically, ESG issues have been misidentified as different from other major categories of risk such as enterprise, business-management and emerging/ non-traditional risks.
     - ESG risks fall squarely within mainstream business risks that companies consider as a matter of course throughout the risk identification process.
   - How could these risks interrelate? When could these risks manifest?

2. Evaluate whether existing processes allow the discovery of ESG risks.
   - What is the company's process to identify risks from ESG factors? Which ones are the company already tracking?

3. Look to a range of sources in identifying ESG risks.
   - What sources were consulted to determine the company's ESG risks?
     - Having a cross-functional corporate sustainability team with representation from functions including operations, supply chain, legal, communications and investor relations can assist in identifying the range of these risks.
   - What are our corporate peers doing on ESG risks? What ESG issues do our top investors think are most relevant to our sector?

4. Be aware of assumptions in the risk identification process.
   - Did management assess ESG risks that the company could face in 1, 5, 10 and 20 years? What blind spots about ESG risks may exist in the risk identification process?

5. Integrate identified ESG risks into the Enterprise Risk Management (ERM) process.
   - Who owns the ERM process internally? Does the ERM process consider ESG risks? Is the ERM process agile?

**Risk assessment:** Management should then assess and prioritize risks to direct the board's focus on those topics most relevant to the achievement of key strategic objectives.

1. Evaluate the information the board receives on prioritized risks.
   - Does the heat map appropriately reflect ESG risks?
   - Has the company performed a scenario analysis on the most relevant ESG risks and their possible impacts on the company?
Boards should also be aware of the contagion effect of various ESG risks and that when one event or risk is realized it may have a domino effect.

- **Management can provide boards** with the following pieces of useful information:
  - Explain how the internal risk identification process surfaces relevant ESG risks.
  - Map top trends facing the company and identify how these issues could pose ESG risks.
  - Present the results of scenario analyses on top ESG risks, including climate change.
  - Benchmark where the company ranks as compared to its peers on ESG issues.
  - Propose quantifiable, time-bound metrics to address ESG risks, and how achieving these results will impact the profit and loss statement of the company over the short, medium and long-term.
  - Highlight relevant media on top, sector-specific ESG trends with an explanation of how these trends could financially impact the business.

2. **Use a materiality lens.**
   - Do the prioritized ESG risks materially affect the company?
     - A growing number of governance professionals assert that “determining materiality is at the essence of directors’ fiduciary duty and it is the basis for establishing the legitimacy of the corporation’s role in society.”
   - Have we considered stakeholder and shareholder input in making this determination? Have we considered how the ESG risks may interrelate?

3. **Consider the board’s skills to evaluate ESG risks.**
   - Do we discuss our ESG risks at regular intervals?
   - Is the board regularly briefed on relevant ESG trends and how these trends could pose risks to the company?
     - Recruit directors with the experience and exposure to material ESG issues that the company faces.
     - Educate the entire board on relevant ESG issues.
     - Engage with relevant stakeholders and shareholders on ESG risks.

4. **Ensure that prioritized ESG risks are surfaced appropriately in board discussions about corporate strategy,** whether at the committee or full-board level.
   - Do we discuss our ESG risks at regular intervals? Are ESG issues addressed systematically? How are ESG issues integrated into our strategic planning and execution?

**Risk mitigation:** Boards should evaluate how the top ESG risks affect the business to make decisions that help the company navigate the risks in question.

1. Consider how prioritized ESG risks affect organizational strategy.
   - What is our risk tolerance for ESG-related factors? Is the company prepared to respond in case ESG risks manifest?
   - Who has responsibility for managing identified and/ or prioritized ESG risks?
     - While each company will approach the task of assigning risk owners differently, companies need to ensure that ESG risks do not remain siloed within the sustainability team and are evaluated within the ERM process.
   - Could the ESG risks we face disrupt our business model?
   - What business opportunities do these ESG risks present?
     - Business opportunities stemming from ESG risks are on the rise.
     - Annual global investment in climate solutions is over $1 trillion and growing.
     - In emerging markets, the investment opportunities created by the transition to a low-carbon economy are estimated at over $29 trillion between now and 2030.

2. Understand what strategies are available to mitigate or adapt to ESG risks.
   - Can the company avoid the risk? Does the company have a plan for managing the risk?
• If the company can neither avoid nor manage the risk, **what adaptation measures** might lessen the impact?
  
  o Capital allocation: Boards should **subject capital allocation decisions to a review** of how they will be impacted by priority ESG issues.
  
  o M&A: Boards could evaluate **how proposed partnerships or acquisition targets can help or hurt** the achievement of the company’s sustainability goals.
  
  o Policy advocacy and lobbying: Boards should **oversee the company’s public policy positions on ESG issues**, and ensure that there is consistency among key risks, disclosures and the company’s lobbying.
  
  o Insurance: Boards should **oversee the Chief Risk Officer’s purchase of adequate insurance** to mitigate ESG risks, including property insurance and business interruption insurance.
  
  o Value creation: Material ESG risks may surface that force the company to **evaluate how much longer its business model is viable** and take steps to transition to a profitable long-term solution.
  
3. **Hold executives accountable** for addressing ESG risks.
  
  • To what extent are prioritized ESG factors **linked with executive goals and performance**? How are ESG factors **incorporated in executive compensation** in both the short and long-term?
  
**Structuring Board Oversight of ESG Risks**: Developing formal structures to **deliberate on ESG factors and corporate risk and strategy** allows them to be addressed proactively.

1. **Formalize oversight** of ESG risks at the board level.
  
  • How is the board currently structured to oversee ESG risks? Would explicit **reference to ESG in a committee charter** enhance the board’s approach? How should the **audit committee** address ESG risks? When should ESG factors be **elevated for consideration** by the entire board?
  
2. Ensure **coordinated deliberations on ESG risks** across committees.
  
  • How could ESG fit into deliberations taking place across the board committees? How could these deliberations be better coordinated?
  
**Disclosing ESG Oversight**: Companies should **identify their priority audiences and customize disclosures appropriately**.

1. Disclose the board’s role in overseeing ESG risks.
  
  • What should the company disclose about the role of the board for ESG risk oversight?
    
    o As **investor attention on ESG risks continues to intensify**, companies should provide decision-useful disclosure of how a board oversees ESG risks.
  
2. Disclose material ESG risks in financial filings.
  
  • Which ESG risks should be disclosed in financial filings? What information are investors looking for on ESG risks?