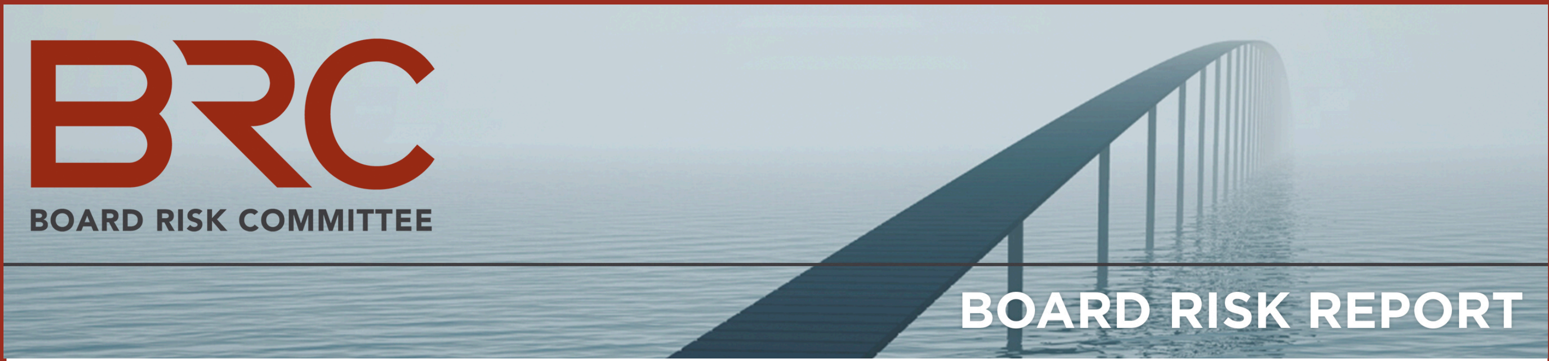

January 15, 2021

2021: ESG ASCENDS IN AN EVOLVING RISK LANDSCAPE

By Catherine Allen and Gary Roboff

Environmental, social, and governance (ESG) concerns will be a top priority for boards in 2021 and beyond. Boards will be increasingly focused on environmental, diversity, social responsibility, resource sustainability, appropriate governance, and other ESG issues. However, the United States lags other regions in its attention to ESG issues and too often both boards and investors do not see an economic advantage in pursuing them. A recent Royal Bank of Canada (RBC) Global Asset Management Responsible Investment Survey found that just 65% of firms in the United States view ESG issues as important in investment strategy and decision-making, versus 94% in Europe and 89% in Canada. Frustrated Exxon-Mobil shareholders are mounting a significant effort to oust a set of board directors because of an ongoing lack of attention to ESG issues. The unfortunate reality is that too many boards are not structured to optimally consider ESG issues and understand the benefits that would come from addressing their impact.

WHY IS ESG OVERSIGHT SO IMPORTANT TO BOARDS?

Increasingly, boards recognize that the right ESG policies can generate significant economic value. Boards also recognize that failure to appropriately manage risks arising from ESG issues can lead to reputational issues, government regulation and enforcement actions, private litigation, and an increasingly negative impact on shareholder value. Adoption of ESG principles is growing globally, according to the recent 2020 RBC Survey. Overall, more than 75% of the respondents integrate ESG principles into their investment approach and decision-making. The pandemic has required boards and investors to pay greater attention to supply chain risks and a host of ESG issues, including workplace culture and safety. Investor advisory groups, such as Glass-Lewis and ISS, and large Investors, such as BlackRock (an ESG leader) and State Street Global Advisors, are increasingly emphasizing ESG in corporate proxy disclosures and director elections materials. These firms understand the consequences of climate change, are uneasyabout social unrest, and acknowledge the increased scrutiny coming from regulators.

ESG is a priority on advisory firms' suggested 2021 board agenda items. For example, KPMG's Board Leadership Center's 2021 Board Agenda identifies COVID-19, human capital management and CEO succession, combating systemic bias and racism, refocusing on ESG, and crisis readiness and resilience asits top five focus areas.

A recent Pew Research Survey shows 9 of 10 consumers believe corporations should be accountable for more than profit. Younger generations such as Millennials and Generation Z want to work for companies that align with their personal missions and those cohort groups look at how companies are handling issues such as climate change and diversity and inclusion. To attract and retain talent now and in the future, boards need to understand the demographic changes that are driving attention to ESG.

What Can Boards Do?

- Talk to your investor relations executives as well as your investors about what your organization's strategy is around ESG.
- Have regular discussions at the board level on ESG.
- Make sure your proxy statements have appropriate information about board oversight and disclosure of issues.

HOW ARE REGULATORS IN THE US AND ABROAD LOOKING AT ESG?

Regulators are paying increasing attention to ESG risk issues, but until now not always with consistent direction. President-Elect Biden, however, has made environmental and social issues a key part of his policy agenda.

At a global level, the Financial Stability Board's (FSB's) Task Force on Climate-related Financial Disclosures has issued a consulting paper on Forward-Looking Financial Sector Metrics (comments accepted through January 27th). The European Banking Authority has an open consultation on an approach to incorporate ESG risks into the governance, risk management and supervision of financial services companies (comments accepted through February 3rd). In early December, the U.S. Securities and Exchange Commission's Asset Management Advisory Committee issued preliminary recommendations that would require the adoption of standards through which corporate issuers would disclose material ESG risks.

Boards should anticipate that ESG disclosure requirements (and eventually compliance responsibilities) will apply broadly and will extend to organizational supply chains, including mandatory requirements for vendor disclosures as part of periodic third party risk management due diligence.

What Can Boards Do?

- Make sure your organization examines current, and draft, ESG regulations to understand and comment upon regulatory direction.
- Encourage management to review your organization's ESG risk management strategy with regulators and to explain its thinking about particularly important ESG elements.
- Ensure your organization will be able to comply with ESG regulations as they are released.

ESG METRICS: THE ESSENTIAL - BUT NOT QUITE READY FOR PRIME TIME - RISK MEASUREMENT TOOL

It is difficult for any organization to know whether it is managing ESG risks effectively without a set of widely accepted ESG metrics in place. In recent introductory language to rules limiting investment advisors' ability to incorporate ESG considerations into some retirement portfolios, the "EBSA concluded that the lack of a precise or generally accepted definition of 'ESG,' either collectively or separately as 'E, S, and G,' made ESG terminology not appropriate as a regulatory standard." Others have recognized the issue and are attempting to address it.

One important effort, led by the World Economic Forum (WEF), issued suggestions last September. WEF's proposed cross-sector metrics, designed to work across all industries, were based on five key criteria:
-consistency with existing frameworks and standards
-materiality to long-term value creation
-extent of actionability
-universality across industries and business models
-monitoring feasibility of reporting

We believe a two-tier set of metrics will eventually emerge – first, a smaller set of ESG metrics that are appropriate to organizations across all sectors; and second, sets of industry-specific ESG metrics.

What Can Boards Do?

- Make sure your organization is paying close attention to emerging ESG Metrics.
- Be sure that your organization offers carefully considered perspectives when regulators are requesting feedback on proposed ESG metrics (many are).
- Establish and track progress to achieving a clear set of ESG organizational goals.
- Ensure your organization will be able to comply with ESG regulations as they are released.

HOW ARE BOARDS ADDRESSING ESG ISSUES FROM A GOVERNANCE AND STRUCTURAL PERSPECTIVE?

Many boards are approaching ESG discussions either at the full board level or parsing issues to various committees, including:
-Audit or risk committees to oversee ESG related risks,
-Compensation committees to ensure diversity and inclusion,
-Corporate governance committees often to add a responsibility for overseeing sustainability issues,
-Public responsibility committees which oversee matters such as sustainability and other public policy issues that reflect organizational character and can impact reputation among all stakeholders.

Board risk committees can bring unique value-add when overseeing ESG related risks because they can best place those risks within an organization's overall risk framework. That is important because one group of risks will likely impact others and overseeing any set of risks in a vacuum may create a sometimes strikingly incomplete picture of the risks actually facing an organization.

What Can Boards Do?

- Ensure that ESG oversight responsibilities are distributed to committees with appropriate expertise.
- Recruit ESG talent to the boards and establish regular full board ESG briefings, at least on a quarterly basis.
- Review your organization's ESG policies, strategies, and risk appetite on a regular basis.
- Update the organization's risk profile to include all issues related to ESG.
- Invite outside experts to brief the board on such issues as climate change, diversity (including board diversity) and inclusion, and social unrest.

RESOURCES

Royal Bank of Canada (RBC) ESG Executive Summary

KPMG: On the 2021 Board Agenda

TaskForce On Climate-related Financial Disclosures - Consultation and Input

EBA Consultation to Incorporate ESG Risks Into Governance, Risk Management and Supervision of Credit Institutions and Investment Firms

U.S. Securities and Exchange Commission Asset Management Advisory Committee Potential Recommendations of ESG Subcommittee

Final Rule on Financial Factors in Selecting Plan Investments

Measuring Stakeholder Capitalism Towards Common Metrics and Consistent Reporting of Sustainable Value Creation

10 Ways Corporate Boards Need to Approach Risk in 2021

C-Suite Call to Action – Risk Management Through A Different Lens

"ESG is real, it took off a while ago, it's going to continue to grow.... It needs to be done maturely and intelligently."

Jamie Dimon
Chairman and CEO
JP Morgan Chase & Company

ABOUT THE AUTHORS

Catherine Allen is Founder and Chairman of The Santa Fe Group and a corporate board director for privately held and family businesses. She formerly served on the public corporate boards of NBS Technologies, Stewart Information Services, Synovus Financial and El Paso Electric Company. She has created, chaired and sat on numerous Board Risk Committees. She was named one of the NACD Most Influential Directors in 2018 and sits on the Advisory Board of Women Corporate Directors.

Gary Roboff is Senior Advisor to The Santa Fe Group and a former financial services executive at J.P. Morgan Chase. Gary has served on the Board of Directors at multiple companies and organizations including ISTPA, the NYCE network, and the Electronic Funds Transfer Association. Gary served on the Board of Trustees at Clark University for 12 years, nine of them as Board Vice Chair and as Chair of the Board's Strategic and Financial Oversight Committee.

WHO WE ARE

The Board Risk Committee (BRC) is a non-competitive thought leadership peer forum dedicated to Board Risk Committee members and Chief Risk Officers (CROs). The BRC is a trusted place for the exchange of ideas, best practices, and topics of interest. BRC is affiliated with The Santa Fe Group (SFG). SFG is a strategic advisory company providing unparalleled expertise to leading financial institutions, healthcare payers and providers, law firms, educational institutions, retailers, utilities, and other critical infrastructure organizations.

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