Boards and Sustainability: Don’t Wait for Regulation

“Long-termism” is increasingly being used to describe the shifting expectation shareholders and broader stakeholders have for boards to incorporate sustainability matters into their corporate governance mandate. While formally and legally mandated to ensure the longevity of the organization and focus on the long-term, corporate boards face relentless, albeit outdated pressures from financial markets for short-term profit maximization. Could emerging regulation be seen as the answer to help bolster long-termism in corporate governance? How can boards be proactive about integrating sustainability into their responsibilities?

What regulated sustainability could mean for boards

A big question for boards is more likely *when, not if*, the consideration of environmental, social and governance (ESG) factors will become a legally mandatory part of their duty. A recent study by the European Commission and EY concluded that an EU “policy intervention” is the most effective way to correct the time horizon in corporate decision-making and promote a corporate governance that explicitly considers and addresses sustainability matters.

If European policy shifts are a harbinger for what’s to come in other regions, companies can expect more regulation around corporate sustainability. What might that look like? For one, a more explicit articulation of the duty to act in the best interest of the company and the duty to balance the interests of multiple stakeholders; perhaps a legal obligation to identify and mitigate environmental and social risks and impacts; stricter regulations on corporate sustainability disclosures; or even the obligation to include specific ESG metrics in executive (and board) remuneration.

How boards can prepare

Of course, boards can choose to wait for regulations to be enacted to implement any prescribed measures. But why wait? To understand the sea change towards corporate sustainability is to understand the benefits both to the company and to the ecosystem which supports its existence.

Change does not come easily and requires leadership. Stakeholders in general and investors in particular are looking for "tone at the top"–in other words, ways in which directors demonstrate how they integrate sustainability to responsibilities within their purview: governance, strategy, risk management, and reporting.

Adopt a framework around purpose

Perhaps the first step to defining and iterating tone at the top is to articulate the organization's purpose. According to George Serafeim of Harvard Business School, a purpose statement "should define how the company aims to create value by fulfilling unmet needs in society. It should acknowledge the negative impacts the company must mitigate if it is to retain public support and its license to operate. And it should present a distinctive message—not something so generic that the name of any major competitor could be substituted." This kind of purpose statement would certainly set the tone.

Determine material issues

Directors, either at the committee or full board-level, should ask their management teams to determine the most material ESG issues to the business. Often this assessment is done through a lens of what issues have the highest impacts on your business and what issues are "within your control." SASB provides companies with clear standards on what topics are most financially material to their given industries. More holistic approaches to sustainability involve consulting multiple stakeholder groups to determine material topics. Traditionally, these were done every few years. In Novisto's recent white paper, we argue that technology-enabled dynamic materiality tools will help companies keep up with evolving sustainability-related, business-critical issues.

Integrate those issues into existing enterprise risk management

A key part of directors' fiduciary responsibility is the "duty of care" to adequately inform themselves on these material issues prior to making business decisions. It's important for boards to understand that managing sustainability risks should not require different approaches or significant additional resources to their enterprise risk management process. However, determining whether this existing process can adequately uncover ESG risks is also an important step to integrating these issues effectively.

Benchmark against peers on performance and sustainability reporting practices

Sometimes, there is no better place for boards to start with sustainability than benchmarking their current governance structure and disclosures against peers, both inside *and* outside of their industry. Such an exercise needs to be done regularly with the backdrop of a quickly changing competitive landscape where companies are learning to pivot to address the growing information requests of investors, lenders, customers, employees, and other stakeholders.

From tone at the top to clear actions

A concrete way to demonstrate your board's commitment to sustainability is to include explicit director oversight responsibility in board and/or committee charters. Another is to consider creating a specific, cross-functional committee dedicated to sustainability/ESG oversight. A recent survey highlighted by an INSEAD Corporate Governance Centre report found that only 17% of boards have a dedicated sustainability committee, pointing to the persiting need for greater board attention. Incorporating sustainability-related expertise to the board skills matrix, and recruiting new directors with specific expertise and diverse profiles are other clear actions boards can take. ESG-minded investors are increasingly looking for these elements as a proxy for the quality of sustainability oversight and risk management exercised by the board.

Demystifying the actionable ways sustainability can–and should–be included in existing corporate governance practices is key to getting hesitant (or even resistant) directors on board. Boards and management teams will have increasing accountability for ESG performance and thus will need to be more in control of ESG risks and opportunities, confident in the data presented, and supportive of adopting best practices and tools to master sustainability management. As always, when it comes to sustainability, it's a continuous improvement process. The important thing is to start, and the time to start is now.