مركز الحوكمة
CENTER FOR GOVERNANCE

THE BOARD'S ROLE IN ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG)

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A PIF COMPANY

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INTRODUCTION

The paradigm shift to sustainability is rapidly gaining ground in today's corporate world. Stakeholders, including investors, lenders, workers, and consumers, seek environmental, social, and governance (ESG) data to make their decisions. ESG has become a mainstream consideration for boards, and the board has assumed a pivotal role in monitoring and incorporating ESG risks and opportunities into their organizations' duty of care; violation might also occur if ESG considerations are ignored. In light of this, the Centre for Governance (CFG) sought to illustrate how boards structure oversight of ESG issues.

ESG

ESG refers to a company's environmental, social impacts and governance structures. Environmental criteria examine a company's ecological stewardship, as its activities may affect the surrounding environment, ecosystems, natural resources, and species extinction. Energy and water consumption, waste management, carbon emissions and climate change are examples of the environmental impact. Social criteria evaluate how a business interacts with its stakeholders, including workers, vendors, consumers, and local communities. Workplace diversity, business ethics, employee health and safety, and public welfare are also components of the social impact. Governance includes the board's accountability, transparency, and protection of shareholders' rights. Thus, governance relates to a company's leadership and internal processes, including executive remuneration, internal controls and assurance, board diversity, ethical decision making, and shareholders rights.
The following are examples of themes that may be classified as environmental, social, or governance:

Environmental

Renewable fuels
Recycling processes
Emergency preparedness
Energy efficiency
Climate risk

Social

Health and safety
Working conditions
Employee benefits
Diversity and inclusion
Human rights

Governance

Ethical standards
Board diversity
Stakeholder engagement
Shareholder rights
Pay for performance

IMPORTANCE OF ESG

Setting aside whether boards are legally obligated to monitor ESG risk, there are good reasons for them to focus on it. Boards should consider ESG strategically as an opportunity to attract investors, clients, and employees. The World Economic Forum issues an annual Global Risks Report, and the hazards have changed dramatically over the last decade. In 2008, just one of the top five risks was related to ESG. In the 2023 report, four of the top five hazards are related to social and environmental factors. The top five list consisted of cost-of-living crisis, natural disasters and extreme weather events, failure to mitigate climate change, erosion of social cohesion and societal polarization. ESG risks formerly considered "black swans" have become more widespread and may soon have a substantial impact. Companies report on their ESG or sustainability performance for several reasons: Investors, clients, lenders, insurers, and other stakeholders increasingly identify that a company's financial performance is tied to its sustainability-related issues. Companies need to generate comparable, trust- worthy, and timely ESG disclosures to meet the information needs of these stakeholders. As a result, the world's leading funds, including BlackRock, Swiss Re, CalPERS, Allianz, and Pension Denmark, consider ESG when making investment decisions, and some have committed to making their portfolios carbon neutral by 2050. According to a 2021 PwC report, more than 80% of typical investors now consider ESG information in their investment decisions. There are now over $25 trillion of assets managed using responsible investing strategies, an increase of 25% since 2014.
A survey on ESG conducted by McKinsey and published in February 2020 showed that 83% of executives and investment experts believe ESG would boost shareholder value. Also, investors indicated that they would pay a median premium of around 10% for a firm with a good ESG track record compared to a company with a poor one.

MARKET DRIVERS	REGULATORY DRIVERS	VALUE CREATION
• Over 80% of investors now consider ESG information in their investment decisions. • The world's leading funds incorporate ESG factors into their investment decisions.	• SEC has proposed new climate disclosure standards for all US-listed firms. 99% of S&P 500 companies disclosed ESG information in 2021. • Companies doing business in EU member states must follow specific criteria to improve ESG disclosure.	• Companies with higher ESG achieved higher valuations than non or lower ESG competitors. • Investors would pay a median premium of around 10% for a firm with a good ESG.

3.1 Importance of ESG

Governments worldwide are reacting to the demands of their respective markets by enacting policies that encourage sustainability and increasingly requiring ESG disclosures from businesses.
For instance, in the US, the Securities and Exchange Commission (SEC) has proposed new climate disclosure standards for all US-listed firms, which may go into force as early as 2024. By the end of 2018, 85% of S&P 500 firms had already issued an ESG report. Since 2017, companies doing business in EU member states must follow specific criteria to improve ESG disclosure as per the EU Non-Financial Reporting Directive. Given the significance of incorporating sustainability into effective corporate governance, the OECD advocated including sustainability in the OECD Principles of Corporate Governance.

3.2 Value Creation

Companies may improve their financial performance and create economic value by assessing and controlling major ESG issues, including growth prospects, operational expenditures, risk profiles, and employee satisfaction. Research confirms that companies with higher ESG achieved higher valuations than non or lower ESG competitors. FedEx, for instance, aims to replace its entire 35 thousand vehicles by electric or hybrid vehicles; they have replaced about 20% so far, reducing their fuel expenditures by about 50 million gallons.

THE BOARD'S ROLE IN ESG

ESG oversight is the primary responsibility of the board. However, how boards carry out their monitoring roles varies by company structure, business sector, and legal system. Responsibility for ESG oversight lies with the board of directors as part of their fiduciary duties. Boards have ultimate responsibility for a company's sustained prosperity and expansion. Consequently, it is essential for the board to have members who possess ample sustainability knowledge. The Board's primary duties are to guarantee the following:

- Relevant ESG issues are included in the company's purpose, governance, and risk management, decision- making processes, and reporting.
- There is a firm understanding of and alignment with ESG priorities.
- ESG metrics and targets are established and monitored.
- Adequate reporting ensures that material ESG issues are communicated.

Incorporating ESG into purpose and strategy to ensure that companies are doing the right thing for stake-holders is a responsibility of the board. An essential component of this integration is how a firm addresses the requirements and expectations of its stakeholders in light of the risks and opportunities that may impact value creation.
"Corporate purpose" is the main drive for boards to focus on ESG and their firm's long-term performance. A distinctive mission can direct a company's decisions to enhance its environmental and

social impacts. Companies with a purpose can lead a sustainable strategy, and the primary responsibility of the board is to determine the company purpose. Aligning ESG objectives with other strategic targets, notably financial goals, and holistically considering ESG can help ensure the essential trade-offs are adequately understood. ESG is intertwined with corporate responsibility, corporate governance, and accountability. A firm's board of directors should be involved in the ESG process from the start so that they may advise and monitor the company as it develops its ESG priorities and objectives. To have a meaningful impact, ESG must be central to the organization's culture and built into the fabric of its operations. Effective board oversight necessitates understanding how ESG factors are incorporated into business decisions, including strategic choices and enterprise risk management. Boards of directors should oversee ESG risks as they would with any other risk, and ensure the development of a process for identifying and reporting on those risks. It is becoming common practice to include ESG factors in executive performance related compensation to incentivize the proper behaviors and hold people in leadership positions accountable for accomplishing the company's ESG objectives. In addition, it may aid in aligning efforts toward critical goals. The challenge of disclosing ESG in annual reports can be tackled by conducting a materiality assessment to determine the company's priorities and build toward the ESG story that needs to be told. This should also include double materiality, not just considering the effect of ESG on corporate activities but also the effect of corporate activities on ESG. Several factors, including a company's industry, size, geographic reach, business operations, and business model, may drastically alter the weight that ESG concerns carry for a given enterprise.

"Board of Directors are highly advised to address ESG risks as part of their fiduciary duty to enhance the company's long-term value."

Currently, there are some challenges in trusting corporate ESG reports. Biases caused by greenwashing (reporting only the positives) can mislead investors looking to invest in businesses that match their performance expectations and ethics. Therefore, boards should exercise active oversight in this area to foster trust and transparency in ESG data by providing visibility over the entire reporting process, accountability, traceability, transparency, controls, and procedures to guarantee the reliability of the data, accuracy, and completeness of disclosures. Information that is commonly disclosed in ESG reports includes the structure and frequency of ESG reporting concerns to the board and relevant committees; directors' ESG expertise; the allocation of ESG oversight responsibilities among the board and its committees; ESG risks, opportunities, and mitigation approaches; and how ESG corresponds with the company's long-term business strategy.

ESG OVERSIGHT STRUCTURE

Board structure, number of necessary committees, and whether the board will allocate responsibility to its sub-committees for ESG supervision are matters for each company to consider based on legally required regulations. Corporate committees' structures and responsibilities are changing to address ESG issues more effectively. ESG oversight approaches include:

OVERSIGHT BY THE ENTIRE BOARD

Some boards may choose to keep primary supervision for ESG at the board level since a successful ESG strategy should match with and be included in the business's purpose and strategy. In this method, boards dedicate substantial time at board meetings to discussing ESG issues. When necessary, boards may also consult an outside subject-matter expert. Smaller organizations and boards with fewer independent members may benefit from this approach. However, many businesses use a hybrid model in which the board works with other committees to oversee ESG.

OVERSIGHT BY SUSTAINABILITY COMMITTEE

Companies may also form a new, independent committee to oversee ESG. With this method, firms can have in-depth and regular discussions on ESG. However, it risks isolating ESG discussions from other vital business functions such as operation, finance, and strategy. To reduce this risk, the chairperson or a representative of other board sub-committees concerned with ESG might be invited to sit on the sustainability committee. A more efficient synthesis of ESG concerns for the board may be achieved by consolidating committee reporting by having a single committee report to the board rather than several reports from several committees.

OVERSIGHT BY EXISTING COMMITTEES

In the early phases of implementing an ESG strategy, it may be beneficial for some companies to outsource supervision of ESG to an existing committee (such as the audit, remuneration, nomination, risk, or investment committee). While 67% of S&P 100 firms divide ESG responsibility between two or more committees, 54% of FTSE100 firms (and 100% of oil & gas firms) have established ESG committees at the board level.

The board delegates its ESG monitoring authorities among its committees, expecting each committee to report back to the board regularly. This approach encourages the incorporation of ESG into operational procedures. Companies adopting this strategy are amending the existing committees' names and charters to reflect their expanding responsibilities. Given the broad nature of ESG, existing committees may share the responsibility of monitoring ESG. For example:

- Overseeing ESG risk management falls within the risk committee's responsibility.
- Internal controls, transparency, regulations, and assurance concerning ESG matters fall within the audit committee's responsibility.
- Compensation and incentives related to ESG considerations are performed by the remuneration committee.
- The investment committee considers finance and investment options related to ESG.
- The nomination committee considers ESG experience when nominating directors and board members.

"The Sustainability Accounting Standards Board (SASB) has issued a set of industry- specific standards that identify material issues per industry and recommended disclosures against each issue."

Regardless of organizational structure, boards must prevent roles from being duplicated and must keep committees' agendas connected. Having board members serve on all committees is one method to guarantee the Board's active participation in critical ESG issues. Even if the board distributes authority over ESG oversight to one or more committees, the board maintains ultimate responsibility.

ESG IN SAUDI ARABIA

As part of the Saudi 2030 vision initiatives, the Kingdom of Saudi Arabia is dedicated to enacting sustainable development appropriate to the kingdom's unique circumstances. The Ministry of Economy and Planning's 2018 Voluntary National Review details the Kingdom's progress toward all 17 Sustainable Development Goals (SDGs) and illustrates plans to strengthen its position in sustainable development. To carry out its mission and connect PIF's wide range of sustainable projects with sustainable funding, PIF published the Green Finance Framework in February 2022.

By joining the United Nations Sustainable Stock Exchanges Initiative in 2018, the Saudi Stock Exchange "Tadawul" aimed to raise awareness of ESG issues and inspire sustainable investment. In 2017, Tadawul issued voluntary ESG guidelines for Saudi-listed companies to help them navigate ESG.

In January 2023, the GCC Exchanges Committee released a standardized set of ESG disclosure metrics aligned with the World Federation of Exchanges and the Sustainable Stock Exchanges framework. The metrics include issues from greenhouse gas emissions and water consumption to staff turnover and gender diversity to data protection and ethics. This is a crucial move toward aligning ESG disclosure in the GCC states. The framework serves as guidelines for businesses that want to start disclosing their ESG activities.

In light of rising expectations that governments around the world will use sustainable finance to fund "green" projects like carbon credit programs and markets, nuclear, carbon capture and confinement, biofuels, solar power, green hydrogen, and renewable energy sources, Saudi Arabia is putting more emphasis on ESG initiatives. Last year, the PIF announced the launch of the Regional Voluntary Carbon Market with a ($133 million) capital, and it was announced on the Saudi Green Initiative Forum that Saudi Arabia aims to reach Net Zero by 2060 through the Carbon Circular Economy approach.

Saudi Arabia has made a significant leap in environmental regulations, which are becoming more stringent. This means ESG litigation is making its way to Saudi Arabia. It is also of particular interest to Saudi corporations with operations or assets abroad because of the potential for ESG lawsuits and liability. Damage to a company's image and loss of value among its stakeholders may result from ESG-related criticism and "greenwashing" charges. Therefore, Saudi companies should consider continuous improvement of their implementation of ESG risk management tools and strategies.

DIRECTORS SHOULD ASK

The board and relevant committees should ensure that ESG is a part of their agendas and is effectively managed. The following questions will help directors fulfil these responsibilities:

01

Is ESG integrated with the company's purpose, strategy, and governance? If not, the board should consider whether it should be and whether stakeholders' ESG expectations are met.

02

Has the company assessed ESG risks and opportunities? Does the company have an approved ESG plan with clear performance targets and metrics? Has the company allocated sufficient resources to manage ESG risks effectively?

03

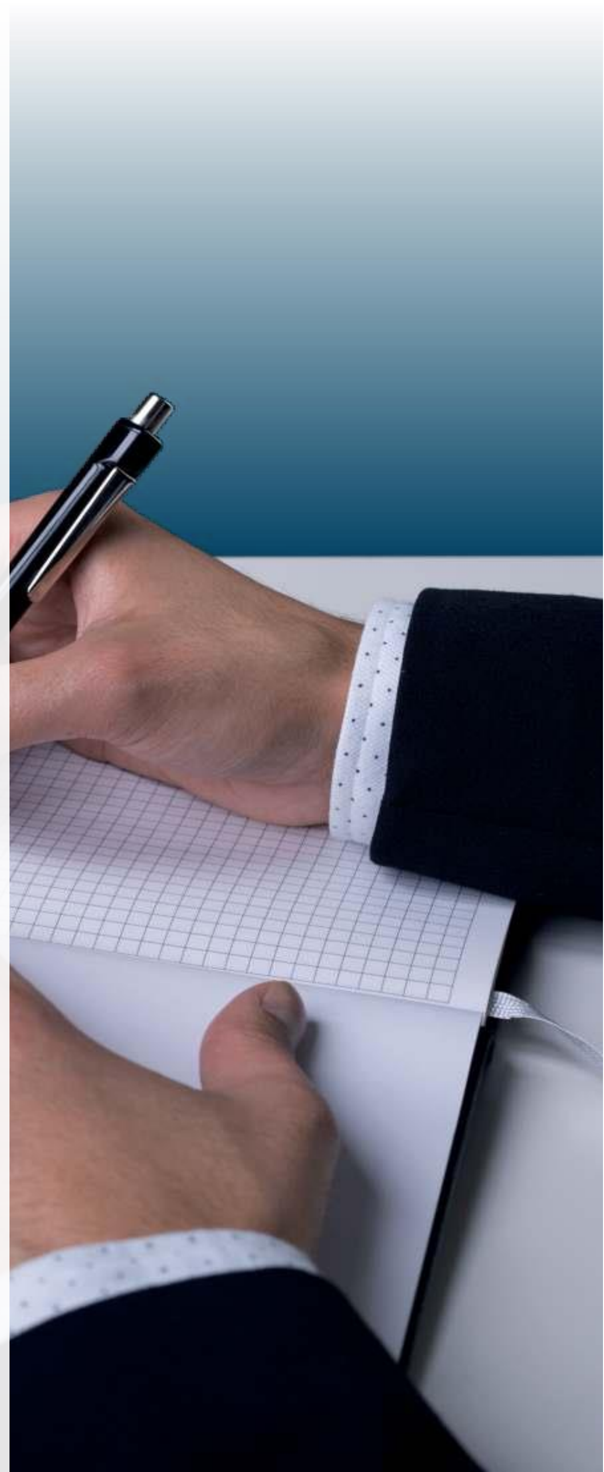
Does the company have an established policy and framework for ESG that identifies and coordinates the right employees, departments, and committees to define the roles, responsibilities, and competencies required for ESG reporting?

04

Are ESG risks in operational areas understood, managed, and appropriately reported? Is there ESG awareness training for the workforce, including contractors and suppliers? Are ESG requirements built into employee job descriptions, contractor contracts, and directors' remunerations?

05

Does the company produce a publicly available annual sustainability report detailing its material ESG performance? Does the company have internal processes and auditing arrangements for ESG reporting to verify the accuracy, reliability, and completeness of ESG data?



CONCLUSION

ESG issues are increasingly in the spotlight of today's business world. The board's monitoring of ESG continually evolves, and boards must take a proactive approach to understand the evolving impact of ESG issues on their businesses to foster long-term sustainable value creation. This article outlined the Board's role in effective oversight and governance of ESG matters. There is no one-size-fits-all approach to ESG issues, and each organization should consider their specific structure and circumstances in conducting ESG disclosure and governance. A key challenge is that more guidance is needed on this issue. Strong corporate governance is essential for going forward with ESG and achieving the attitude shift necessary to drive sustainable transformation.

Finally, the ESG monitoring and reporting will support our nation's steps to realize Vision 2030, improve the Saudi capital market, and support the global commitment to accomplish the United Nations' Sustainable Development Goals.

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ABOUT US

The Centre for Governance CFG was established by the Public Investment Fund in 2020. We aim to drive sustainable value creation for Saudi Arabia by enhancing the corporate governance practices. CFG is designed to provide unique solutions to its corporate clients as well as the individuals looking for upskilling programs in the governance domain. Beside the capabilities we have internally, CFG leverages the excellent relationships it has with the world's best institutes and leading global consulting firms. If you would like to learn about our Board Programs and Governance Advisory Service, contact us at info@cfg.sa.

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