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Roadmap to Corporate Sustainability
The Role of the Board in Mitigating ESG Risks

Grow | Protect | Operate | Finance

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Introduction

Environmental Social and Governance ('ESG') is one of the biggest issues in the business world today. While the concept has been around for some time, it began to garner significant traction following the outbreak of the COVID-19 pandemic. ESG relates to the effect that a company's business practices has on (1) *the environment* ('E') in which it operates, including energy resources used, output of waste and the general impact on climate; (2) *social issues* ('S'), such as employee health and safety, human rights, data privacy of customers and employment practices; and (3) *governance* ('G') of the business having regard to issues such as corporate governance, risk management, and compliance.

While ESG continues to trend globally, its rate of adoption and implementation still varies from country to country. According to the latest edition of the Morningstar Sustainability Atlas[1], globally, European countries such as Netherlands, Finland, France, and Belgium lead the pack in ESG practices while Hongkong has been rated as the most sustainable non-European market. The United States of America ranked 16th out of the 48 countries assessed and on the African continent, only South Africa and Egypt were assessed ranking in the 2nd and 3rd categories for overall score.

In Nigeria, ESG has become a subject of interest for stakeholders, particularly investors and public companies and regulated entities are now under pressure to incorporate ESG as part of their overall corporate strategy. As stakeholders' expectations on ESG continue to grow, the Nigerian ESG landscape continues to evolve. It is important to note that Nigeria is the first African country to issue sovereign green bonds and the world's fourth sovereign issuer of green bonds. In addition, there are a myriad of laws and regulations which impose ESG obligations on companies, such as the Companies and Allied Matters Act 2020, the Nigerian Code of Corporate

1. https://www.morningstar.com/articles/1095901/mapping-esg-practices-and-carbon-risk-in-48-countries-stock-markets

Governance 2018, the Securities and Exchange Commission ('SEC') Code of Corporate Governance and the Nigerian Sustainability Finance Principles amongst others. Also, in support of its commitment to the goals of COP26[2], President Muhammadu Buhari signed into law the Climate Change Act, 2021, which was passed by the National Assembly in October 2021. Evidently, ESG is taking center stage in Nigeria with good prospects for corporate entities and the nation at large.

The benefits of ESG are numerous including, better financial performance, reduced business risks, improved employee retention and higher returns on investment. In 2021, the Hewlett-Packard Company ('HP') generated $3.5 billion of commercial sales from new sales in which sustainability criteria were a known consideration and were supported actively by HP's Sustainability and Compliance Organisation and Commercial Organisation.[3] On the contrary, a failure to consider ESG factors in conducting a company's operations has resulted in major business failures.

Further, a growth in ESG reporting mandates in recent years may be an indication that the concept is here to stay. However, much work is still needed to ensure that companies are ready for the ESG revolution, and this is where the role of the board is crucial.

The Board as Drivers of ESG

The ever-changing ESG landscape is a major challenge for boards and their organisations. Boards have to consider company-specific variations, new reporting obligations and lack of investor consensus on ESG preferences and priorities amongst other things. The board being the highest decision-making authority of any organization is responsible for full oversight over ESG issues. It is therefore imperative that the board steps up and shows that it can bear the ultimate responsibility for ESG strategy and compliance within its organization. ESG must now form part of a company's overall corporate strategy and the board must empower its management team to execute that strategy towards achieving long-term value creation for shareholders and all stakeholders.

In addition to oversight, the board must also ensure consistent and strong corporate governance, and a clear understanding of the changes coming down the tracks in the ESG space. In its role as long-term stewards of corporate performance, the board has a critical role to play in ensuring that companies are aware of, and able to navigate, an ever-evolving risk landscape, which now includes ESG risks.

ESG now forms part of each board member's fiduciary obligations to the company and these obligations should not be delegated to others. Acting in the best interests of the company requires board members to be engaged in material decisions impacting ESG matters which are becoming increasingly complex. The fulfillment of these obligations requires that each board member remain informed and objective on ESG matters.

It is important to note that under Nigerian company law, the Companies and Allied Matters Act 2020[4], directors are required to have regard to the impact of their company's operations on the environment in the community where it carries on business operations. The Nigerian Code of Corporate Governance 2018 also recommends that the board should establish policies and practices regarding its social, ethical, safety, working conditions, health and environmental responsibilities as well as policies addressing corruption. The board is also required to monitor the implementation of sustainability policies and report on the extent of compliance with the policies in its annual report.

Undoubtedly, the fiduciary duty of care of directors has been expanded and directors must adequately consider ESG issues prior to making business decisions. Directors must also be able to understand and evaluate the risks arising from ESG factors to be able to fulfil their responsibilities to their company. More importantly, the board should note that investors and stakeholders are looking to it to set the pace and provide the strategy and oversight required to implement ESG In their companies.

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2. 26th Conference of the Parties to the United Nations Framework Convention on Climate Change
3. https://finance.yahoo.com/news/hp-big-sustainability-hit-least-130000085.html
4. Section 305(3)

In summary, the roles of the board in relation to ESG matters include:

1. Understand the impact that ESG has on business strategy and the risk and opportunities that ESG presents. The board should continuously ask itself what ESG risks and opportunities affect its business at any time.
2. Work with management in developing corporate strategies that encompass ESG which can effectively enhance the organisation's performance.
3. Improve oversight of ESG issues and ensure greater accountability on matters pertaining to ESG.
4. Communicate the organisation's position on ESG to stakeholders such as investors, employees and communities, as stakeholders want to see board involvement in ESG matters.
5. Stay abreast of trends, standards and continuously evolving terminology. This will support their expanded oversight responsibilities.
6. Engage with stakeholders to understand their perspective on ESG and what they perceive as effective management of ESG issues.

Overall, the board needs to ensure that there is the foundation of a strong governance structure to make meaningful progress on ESG issues as they affect their companies.

Overview of ESG Risks

A sustainability risk has been defined to be an environmental, social or governance event or condition that, if it occurs, could cause a negative material impact on the value of the investment[5]. ESG is a broad and complex topic covering a multitude of areas, it is only expected that the related risks are equally broad and diverse. Like other business risks, it is important to understand the nature of these risks, to identify them, quantify them, and thereafter manage and mitigate them.

Generally, ESG risks are classified according to their components. Environmental risks which impact businesses include climate change impact, water security, waste prevention and recycling, deforestation, protection of healthy ecosystems and protection of marine resources. It is important for energy and resource intensive companies to be aware of environmental risks and regulations so that long term strategies can be developed. Social risks which impact companies include human rights compliance, data privacy, ethical and labour practices and issues of diversity and inclusion. Social risks have the potential to damage a company's reputation and goodwill, which may affect competitiveness and profitability. The governance risks that impact companies include, board and executive remuneration, board diversity and structure, bribery and corruption, fraud prevention, policies and standards and financial disclosures.

Unlike most other risk types, certain aspects of ESG risks, for example, climate change are emerging with unique characteristics. As such, companies that fail to include ESG factors into their corporate strategy and day to day operations will remain open to ESG risks.

Other classifications of risk as posited by the Harvard Law School Forum on Corporate Governance[6] are outlined in the table below. We have further modified the table to include the risk drivers and outcomes.

5. The Sustainable Finance Disclosure Regulation 2019
6. [Running the Risks: How Corporate Boards Can Oversee Environmental, Social And Governance Issues (harvard.edu)]

Risk Classification	Risk Drivers	Outcomes
Physical risk	Natural disasters, adverse weather and conflict.	The Russian-Ukraine conflict has affected businesses around the world. Wood processing industries that rely on imported timber from Russia and Ukraine are finding it increasingly difficult to obtain inputs. In addition, world supply of gas and fuel have been disrupted and some companies have stopped operations in those countries due to the physical risk (in Ukraine) and economic sanctions against Russia. Nonetheless, countries are already considering alternative options to Russian gas which include the use of coal-fired power plants and other renewable energy sources. The European Commission has announced a €210 billion plan to end its dependency on Russian fossil fuels over a span of five years and speed up its transition to green energy.[7]
Supply chain risk	Shortage of raw materials and natural resources, labour disputes, workforce health and safety incidents and environmental pollution.	The COVID-19 pandemic and the blockage of the Suez Canal by the ship, the Ever Given in 2021 had lingering effects on the supply chain. Days after the vessel was freed, hundreds of container ships were still waiting to get through the canal due to the backlog created by the blockage.
Reputational risk	Shift in consumer preferences and increased stakeholder concern/ negative feedback, breach of laws and anti-competitive behaviour.	Amazon's expansion has led to rapid growth but has drawn intense scrutiny from regulators, governments, and competitors for potential breaches of antitrust laws and anti-competitive behavior. The coronavirus pandemic indicated more systemic occupational health and safety issues, particularly among the warehouse employees, who were exposed to poor safety measures during the pandemic's early stages.

7. EU unveils $220bn plan to ditch Russian energy | Oil and Gas News | Al Jazeera
https://www.aljazeera.com/news/2022/5/18/eu-rushes-out-210-billion-euro-investment-to-ditch-russian-energy

Risk Classification	Risk Drivers	Outcomes
Regulatory risks	Poor legislative monitoring and reporting process, absence of proper governance structures and lack of understanding of regulators' expectations.	Companies in the oil and gas and manufacturing sectors face constant regulatory risk in view of the myriad of legislation in place to curb environmental pollution, carbon emissions, and human rights violations. In 2021, oil giant Shell was fined the sum of $111 million over an oil spill which occurred more than 50 years ago. Also, in the same year, a Dutch Appeals Court ordered Shell Nigeria to pay compensation to Nigerian farmers for damages caused by leaks in the Niger Delta, while the subsidiary and its Anglo-Dutch parent company were ordered to install equipment to prevent future damage.[8]
Litigation risks	Sexual harassment issues, breach of fiduciary duties by directors, participation in money laundering, data privacy issues and human rights claims.	Meta Platforms Inc ('Meta') continues to face multiple lawsuits and fines over privacy violations and its data usage practices, suggesting gaps in its management controls and board oversight. According to the London School of Economics, there have been more than 1,800 cases of climate change litigation in 40 countries as of the end of May 2021. The majority were in the United States of America (1,387), followed by Australia (115), the United Kingdom (73) and the European Union (58). The numbers are steadily growing, and the implications are significant.[9]

8. https://www.bbc.com/news/world-africa-55853024
9. Global Trends in Climate Change Litigation :2021 snapshot https://www.lse.ac.uk/granthaminstitute/wp-content/uploads/2021/07/Global-trends-in-climate-change-litigation_2021-snapshot.pdf

Risk Classification	Risk Drivers	Outcomes
Transition risks	Changing consumer behaviour, increasing cost of materials, innovation and changes in the affordability of existing technologies, change in climate policies, change in equity and debt investor awareness and expectation.	Purchases of Nokia phones declined massively from 2006 to 2013 during the upheaval in the mobile device industry caused by newcomers – Apple, Google and other low-cost competitors. Nokia was unable to keep up with how everyday end users now wanted to use their phones.[10]
Human capital risks	Toxic work culture, negligent hiring, occupational fraud, employee dissatisfaction and workplace disasters.	71% of professionals say they would be willing to take a pay cut to work for a company that has a mission they believe in and shared values. Additionally, nearly 2 in 5 professionals would leave their current job if their employer were to ask them to do something they have an ethical or moral conflict with.[11]

10. https://en.wikipedia.org/wiki/The_Decline_and_Fall_of_Nokia
11. Workplace Culture Trends: The Key to Hiring (and Keeping) Top Talent in 2018
https://blog.linkedin.com/2018/june/26/workplace-culture-trends-the-key-to-hiring-and-keeping-top-talent

How can the Board Mitigate ESG Risks?

Risk management sits at the heart of the board responsibilities of every organisation. The board must therefore establish a framework of prudent and effective controls which enable risk to be identified, assessed, and mitigated with ESG risk being a fundamental part of the risk framework. It is crucial that boards identify the ESG risks that their organisations face. Having considered and identified the risks, boards should work with their management teams to ensure that robust internal controls and governance frameworks are established to mitigate those risks. Boards should then consider what the reporting of ESG risks and strategies is required or expected to address and mitigate the concerns of stakeholders and investors.

Specifically, the board should consider the following as effective ways of mitigating ESG risks:

1. **Establish ESG committees.** To ensure that ESG issues are identified, assessed and benchmarked against industry and international best standards, a standalone sustainability or ESG committee can be structured to include representatives of the audit, compensation, nomination and governance, risk, regulatory, and/or other board committees involved with specific ESG issues. By having one committee rather than multiple committees report to the full board, this approach can also streamline board reporting on ESG matters and facilitate coordination across committees to enable more effective synthesis of ESG issues for the board. In the alternative, since specific ESG matters often already fall within existing committees' areas of responsibility, it is common to formally delegate those specific ESG issues to multiple existing committees.

   Where a standalone sustainability or similar board committee is formed, it should follow the same practices as other board committees, including adopting a committee charter, holding regular meetings, taking meeting minutes and providing reports to the full board. Once responsibilities are allocated and captured in committee charters or other governance documents, they should also be reflected in annual calendars for inclusion on committee and board agendas (as appropriate), just as is the case for other committees and the board.

   Also, as earlier stated, the board should establish policies and practices regarding its social, ethical, safety, working conditions, health and environmental responsibilities as well as policies addressing corruption. The board should also monitor the implementation of sustainability policies and report on the extent of compliance with the policies.

2. **Work with management in determining the company's tolerance for ESG risks:** As a part of this collaboration, boards and management should be clear on who within the organizational structure owns each risk and should ensure that ESG risks do not become the repository of the sustainability team and are instead evaluated within the enterprise risk management process.

3. **Build the ESG mitigation strategy on robust data:** Accurate and reliable data is the crucial foundation of an ESG strategy but can also be a sticky point. Data availability remains one of the biggest challenges companies face, particularly as it relates to transition risk. This is because ESG efforts can be spread across teams and business entities, with no central measurement or relatable data. In view of this, the board must ensure that a good governance framework around data collection is developed. The board must clearly indicate who is reviewing the data received, who is accountable for it at management level and implement effective controls and policies relating to data gathering and capturing.

4. **Disclosure to investors and stakeholders:** As already stated, an effective oversight structure, associated accountability and internal processes and procedures that are appropriate for the company should be developed. Thereafter, the board should develop corresponding disclosures to inform investors and other stakeholders as to how the board is overseeing these issues and ensure that the oversight is supported by appropriate documentation and processes.

5. **Continuously add to the talent and skill management of both the board and management to improve the tone on top:** To further mitigate ESG risks, it is imperative to recruit directors with the experience and exposure to material ESG issues that the company faces. The entire board should also

get continuous education on relevant ESG issues. Finally, the board should consult external subject matter experts on ESG matters affecting their company from time to time to stay abreast of new ESG developments and issues.

6. **Approve the digitization of ESG oversight and reporting:** Digitalization can give the board ESG oversight structure the focus that it needs. The multiple complex metrics and the range of data needing to be mined can be simplified with technology. By digitizing ESG reporting, companies can improve data accuracy and integrity; introduce a more robust sustainability reporting process; make auditing and verification simpler; improve transparency and give all stakeholders up to board level, clear dashboards and metrics showing performance and trends needed for better business decisions.

7. **Hold executives accountable for ESG risk management by asking for regular progress updates and assessing new issues.** Boards should also consider linking a portion of executive compensation to performance on prioritized ESG metrics to underscore the strategic importance of these issues to the company. A strategic tool that can be used to enhance leadership accountability on sustainability is executive remuneration and incentive plans.[12]

8. **Remain forward thinking and agile:** "At the German-based global logistics company DHL, technology driven by ESG considerations has created a new business category. DHL has expanded its business offerings by becoming a developer and manufacturer of electric vehicles (EVs). DHL began incorporating EVs into its transportation fleet in 2013, with the goal of reducing carbon emissions. Its 2014 acquisition of StreetScooter, a small EV manufacturer, allowed DHL to begin to develop its own vehicles. There are now more than 6,000 EVs in DHL's fleet. Public interest and increased third-party demand led DHL to open the second StreetScooter factory, doubling its current production capacity. This is the type of trend expected from a forward-thinking and agile board to ensure that their company keeps up with modern developments. They should be focused on more than the next task at hand or the bottom line alone. Boards of directors, in partnership with management, must anticipate the changes and trends that can result from climate issues and other ESG issues."[13]

To mitigate the risks associated with ESG, boards must continuously question whether they are agile enough to respond to a fast-changing environment, whether they need to rethink their core operating model, whether they are devoting enough time to the ESG agenda and whether they have the requisite data they need and the digital tools to analyse the risks.

12. Running the Risks: How Corporate Boards Can Oversee Environmental, Social And Governance Issues (harvard.edu)
13. Excerpt from interview with Tanuje Dehne, Director Granite Point Mortgage Trust Inc and Advanced Disposal Services https://www.lebow.drexel.edu/news/powerful-role-boards-play-esg-issues

Conclusion

In recent years, ESG has significantly grown to become a matter of importance and priority for companies. Its adoption has also extended beyond the typical large multinational corporations and listed companies to smaller companies for various reasons ranging from greater disclosure/reporting demands from investors and regulators to growing consumer awareness of ethical and environmental impacts of ESG factors. The board remains in the best position to lead the company strategically by acknowledging the importance of ESG and stepping up to the responsibility of ensuring that all ESG matters affecting the company receive careful consideration.

It is also evident that ESG is a growing factor in measuring the success of a company and thus the board needs to ensure that mitigating ESG risk is given the required prominence. As ESG is a broad concept, the board will also need to decide what ESG areas should be prioritized, what results are being targeted, and the expected timeframe. It is companies that are led by proactive boards as it relates to ESG issues that would outpace their competitors, improve profitability, and unlock new sources of value creation.

While the board cannot fully eliminate the risks and must rely on management to implement policies and strategies that are developed, it is key for the board to be decisive in the event of an incident occurrence so as to curtail and correct the effect as soon as possible. Proper risk mitigation would make a company less susceptible to risk and strengthen investor confidence. The reward reflects in long term growth for the company, positive brand equity and better access to financing. The roadmap to corporate sustainability always begins with the board.

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