CIPE

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Corporate Governance Center 20 YEARS

# SUSTAINABLE DEVELOPMENT ON THE BOARD OF DIRECTORS AGENDA

## THESES


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Corporate governance is a journey, it is not a destination. The world around us is constantly changing, new phenomena are coming, and new tendencies are being formed. If we look at the current trends in corporate governance, the most paramount of them is the increase in the professionalism of the board of directors. This is crucial for achieving corporate goals. Deeper focus is coming to corporate culture for proper functioning of companies. In order to have long-term success, companies shouldn't be run purely for the interests of shareholders. There's more and more emphasis on stakeholders' interests. And most importantly, we can see there is a shift from corporate governance towards integrated environmental social governance, so-called ESG.Integrity is about doing right things right even when no one is watching. Integrity is a license to operate for all of us whether we work in a commercial or non-profit organization.

Influenced by those trends, the business model of companies is also changing. In terms of strengthening ESG standards, discussions on circular economy have intensified, challenging companies in terms of waste management and energy efficiency. In addition, companies shouldn't be concentrated purely on their own operations, nor assets. They should monitor how the supply chain operates. This is also an evidence for the move from shareholder towards stakeholder protection.

During our operations in IFC, it was notable that some of ESG aspects were already on the boards' agenda, like internal control and risk management, including environmental and social aspects, remuneration for executives, corporate culture, and focus on long-term goals, etc. Years of our experience prove that wherever we have those environmental and social aspects essential, there's a precondition of success.

Understanding the importance of environmental and social aspects of corporate activities led us to modify IFC's Corporate Governance Methodology that was adopted in 2007. **The CG Methodology updated in 2018** looks at the following parameters:

- commitment to ESG, including leadership and culture,
- structure and functioning of the board,
- control environment, including internal control system, internal audit function, risk management and compliance,
- disclosure and transparency,
- treatment of minority shareholders,
- governance of stakeholder engagement.

Companies are expected not only to concentrate on environmental and social but also governance aspects, including ethics and anti-corruption compliance, remuneration for board members and executives. So, those issues should be on the boards' agenda. This is not like one-off exercise or nice PR activity, but a real point that will open new opportunities for your business and lead to positive results.

Disclosure of information about ESG and ensuring transparency are of no less importance. There is currently no one common standard for information disclosure, which is a real problem for many market players. It also brings some uncertainty for stakeholders such as investors, regulators, etc., which is an additional impetus for developing a standardized approach towards transparency.

So, a question arises as to why boards should deal with ESG. The answer is very easy: it's a part of its responsibilities. At the same time, one should not look at ESG purely from the perspective of it being problematic, dangerous or destructive. It's also an opportunity. The world is changing; the preferences of new generations are changing. They are oriented towards products which are environmentally and socially friendly. That means that some of the products might already be useless, and they might not be demanded on the market. They will be replaced by new products, opening a new arena for business and giving new opportunities for development. Therefore, ESG is both a risk and an opportunity.

To be successful, the board must ensure that ESG standards are integrated in a company's business and its operations. That is vitally important; it needs a strict position of the board. The board shouldn't be afraid to scrutinize and constructively criticize the management team. Otherwise, purely concentrating on financial aspects may lead to increase in number of sales but may damage the culture, which may lead to disastrous consequences for companies.

Let's not say that every board member should be an ESG expert, but the whole board should be able to process and digest the ESG related risks and opportunities and take enough time to discuss them. The board should have a collegial view on ESG related aspects. Of course, in ESG-sensitive industries (such as mining, healthcare, etc.) it will be good to have a person on board with ESG expertise. That person can bring new vision and pay attention of the board members to some points that are important to the company.

One of the important topics in ESG is the board diversity. The more diverse the boards' composition is the better discussions are really possible on boards. The different positions and views on boards are the basis for the development of discussions and culture of debate. Diversity has different aspects. First of all, it is gender diversity. It definitely changes the dynamics of the board of directors; it brings a culture of centralized and more polite discussion to the boards. Women are less risky in their decisions, which restrain boards from making high-risk decisions. It is also really important to have diversity of age on boards. That's needed to understand the expectations of different categories of customers targeted. Young people are much smarter in technical aspects; they have different visions and preferences, which can balance the experience of older board members.

Different kinds of new things are coming to boards' agenda. Therefore, it is necessary to deeply understand the essence of the issues on the boards' agenda. Committees play a supporting role with their recommendations in final decisions made by boards. The formation of committees is very individual. However, there are currently some ESG related trends. In case the company's sector is sensitive to environmental and social risks, those issues can be delegated to the Risk Management Committee. In case 'green' products are developed, 'green' bonds are issued, and 'green' roads are built, ESG issues would be on the agenda of the Strategy Committee. The third option is to form a Sustainability Committee. This is usually the case with large multinational corporations, which must transfer their commitment to meet ESG standards to their subsidiaries.

The benefits of sound ESG are access to capital, better performance, good business reputation, as well as active ownership, especially when it comes to family-owned companies.

ESG is an indispensable component of sustainable finance. This is a relatively new topic. Sustainable finance brings in some new opportunities for all companies. There are different definitions of sustainable finance. For instance, the European Union defines sustainable finance as provision of finance considering ESG aspects. To achieve sustainability, we need energy-efficient solutions, alternative energy and effective waste management systems, and resilience to climate change. We need money for all of this. According to UN estimations, something between $2.5-3 trillion will be needed each year to achieve sustainable development goals by 2030. IFC estimates the climate related opportunities in 21 emerging markets up to $23 trillion.

The climate change agenda was given even more attention by the COP26 International Conference in Glasgow in November 2021. It brought in lots of new commitments, including so-called Glasgow Financial Alliance for Net Zero. It's a group of biggest banks, insurers and asset managers that joined the limitation for global warming to around 1.5°C. This means that those financial institutions will no longer financially support those industries which are not environmentally friendly; they will pay special attention to climate risks when investing.

**Keeping all this in mind it is better to start transition earlier than to be late. It should be remembered that changes take time. When you start doing things gradually it will be less costly compared to when you need to make the change overnight. So, that's why it is better to join the ongoing processes earlier and enjoy their benefits.**