Climate Change, Investors and Boards:

A Perspective from the International Corporate Governance Network

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Between October 31 and November 12, 2021, the United Nations Climate Change Conference of the Parties (COP 26) will bring together world leaders, government negotiators and other stakeholder groups to accelerate actions to address the world's climate crisis and limit global warming to below 1.5°c by 2100. In advance of this meeting, the Inter-national Corporate Governance Network (ICGN), a global organisation led by investors responsible for assets of US$59 trillion, is specifying its view on climate priorities for governments and capital market participants, including company boards of directors.

Our recommendations are based on three observations.

First, climate change presents an existential risk to our society, economy and the ability of companies and investment institutions to create long term sustainable value. Scientists have warned that global carbon emissions have risen by 20% over the past five years with atmospheric temperature increases set to exceed 3°c by 2100 if action is not taken now to wean our dependence on fossil fuels. We are already experiencing weather extremes with intense temperatures, rainfall, floods, fire, and drought. United Nations Secretary-General António Guterres has charac-terized the most recent report of the Intergovernmental Panel on Climate Change (IPCC) as 'code red' for humanity, asserting that *"The alarm bells are deafening, and the evidence is irrefutable."*

Second, the climate crisis is intricately linked to the biodiversity crisis. One example: deforestation releases carbon to the atmosphere and reduces the capacity of nature to store carbon — both significantly exacerbating the climate crisis. In recognizing these kinds of dependencies and interconnections, the IPCC and the Intergovernmental Science Policy Platform on Biodiversity and Ecosystem Services have concluded: "Unprecedented changes in climate and biodiversity, driven by human activities, have combined and increasingly threaten nature, human lives, livelihoods and well-being around the world. *Biodiversity loss and climate change are both driven by human economic activities and mutually reinforce each other. Neither will be successfully resolved unless both are tackled together."*

And **third**, the climate and biodiversity crises have exacerbated social inequality by decreasing life expectancies, disrupting cultures, and impairing the ability of disadvantaged groups to sustain, cope and recover. As the world's economy transitions towards net-zero carbon emissions, workers, communities, and entire regions are in peril of being stranded. This was recognized at COP 21 in Paris when it was stated that: *"Actions must take into account the imperatives of a just transition of the workforce and the creation of decent work and quality jobs in accordance with nationally-defined development opportunities."* The transition towards net-zero must therefore be just, inclusive, and effectively address social inequality as a systemic risk.

For companies and their investors, climate change, biodiversity loss and inequality present physical threats to operations and supply chains, reputational threats (if they are perceived to be inactive and irresponsible by consumers increasingly motivated

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the social responsibility of companies), legal threats as the potential for climate litigation grows and regulatory threats as governments become forced to take drastic action in what is being called the Inevitable Policy Response.

ICGN Recommendations

To tackle climate change, strong public policy, investor stewardship and corporate governance will be critical. Governments will set the agenda and enforce regulation. But corporate boards, management and institutional investors also have critically important responsibilities to clearly identify challenges, determine solutions, and implement assertive action.

For governments heading to Glasgow, ICGN is calling for the establishment of ambitious national action plans and funding for achieving net-zero targets. Legislation and regulation should include such measures as carbon pricing, winding down fossil fuel industry subsidies, phasing out of coal-based electricity generation and strengthening Nationally Determined Contributions (NDCs) for 2030 in line with the Paris Agreement. Governments should also introduce incentives to mobilise private capital towards climate solution investments in renewable energy, resource efficiency, smart technologies and innovative infrastructure investments.

Governments must also support much better corporate disclosure based on the establishment of the International Sustainability Standards Board (ISSB). As proposed by the IFRS Foundation such standards will ensure consistency among sustainability reporting standards, coordinated with standards on financial statements and management commentary. This should include consideration of internationally agreed frameworks, such as the Taskforce for Climate-Related Financial Disclosures and the emerging standard promulgated by the Taskforce for Nature-Related Financial Disclosure. Such reporting is crucial for ensuring the disclosure of material information required by markets and stakeholders to allocate capital appropriately.

Finally, governments should mandate regulations and ensure necessary enforcement resources and sanctions to protect biodiversity, advance conservation and increase protected areas as guided by science. They should work together to criminalise ecocide at the international level. Biodiversity measures and transition plans should protect human rights and incorporate the perspectives of disadvantaged groups and regions adversely impacted by the transition. In addition, countries should ratify and implement relevant labour and occupational safety and health standards that contribute to decent work for workers and businesses affected by the just transition.

For the past few years, major investment institutions have been taking significant steps on climate change but they too must ratchet up their efforts. Investors should now publicly commit to science-based emission reduction targets (including credible interim targets) on how investee companies in portfolios will achieve net-zero greenhouse gas emissions by 2050, while protecting internationally agreed human rights standards and incorporating the views of disadvantaged groups. They should work to improve the quality of climate and biodiversity public disclosure, communicating company engagements, proxy voting and submissions (if any) to governments and standards-setters on climate change and the just transition. Where feasible, investors should collaborate to leverage their influence and align the expectations they have on actions to be undertaken by the companies in which they invest.

Companies should also, of course, publicly commit to science-based targets (including credible interim targets) on how the business will adapt to net-zero emissions by 2050. Transition plans should include assessments of physical and transition risks from climate change scenarios for the company's purpose, strategy, business model, products and services as well as any resultant opportunities. The board should ensure the communication of progress through annual reports to shareholders and other stakeholders.

Companies should also ensure robust governance procedures and board competence in overseeing how management identifies, monitors, measures, and manages climate change risks and opportunities aligned with company purpose and long-term strategy. Effective oversight relies on a genuinely diverse group of directors with relevant knowledge, independence, experience, and cognitive skills to ensure effective, equitable and inclusive decision-making.

Finally, companies should align CEO and senior executive pay and incentives fairly and effectively with the company's purpose, strategy and overall workforce incentives while respecting global best practices. This entails the use of material and quantifiable financial, human, and natural capital-related performance metrics, particularly those associated with the company's net-zero transition plan. The metrics should capture how the company plans to create long-term value by integrating these elements into its business operations.

In this context, board directors must lead. Future observers will ask: did the directors seek to identify potential climate risks? Did they develop an ongoing process for monitoring and identifying new climate risks and have procedures in place to respond rapidly? Did they put the strategies in place to manage climate risks and exploit new opportunities?

As companies move forward on climate change boards should be asking: how do we define our oversight mandate? Are we appropriately organized to assess climate strategy, risks and

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opportunities? Do we share an accurate understanding of climate change? Do we understand the physical, reputational, legal and regulatory risks? How do we keep up on the flow of information and insights on climate change, biodiversity and inequality? What additional training do we need? Are we engaging governments and other standards-setting organizations appropriately? Do we have the right set of organizational memberships, collective initiatives that can ensure the company is effectively informed and engaged?

Finally, and crucially, it must be acknowledged that most boards today are made up of people who reached the pinnacle of their careers at a time when climate change was a fringe issue. It is to be expected that many boards display a critical lack of professional expertise on climate change and a range of other environmental and social issues now moving to the centre of governance. This must change. If boards are to fulfill their fiduciary duty to the corporation, its shareholders and other stakeholders they must embark now on an effective discussion of director skills, experience and succession. When crises occur, all eyes turn toward the board. We are in a crisis. Are you ready?

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