ESG MOVES INTO THE MAINSTREAM (AND THE BOARDROOM)

The journey from a voluntary regime for companies around environmental, social and governance (ESG) topics to a more regulated and compulsory one involving transparency, disclosure and reporting is well underway. Although there are currently no global, standardized ESG reporting benchmark requirements, "hard" law measures with "teeth" are on the rise. D&Os beware….

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THE 1 MINUTE DIALOGUE

- Over 170 ESG regulatory measures introduced since 2018 at the national and EU level. Europe accounts for around 2/3 of all ESG-related regulation
- As investment decisions are increasingly influenced by this new environment, so too is the role of risk management and that of the board of directors.
- Litigation or investor, shareholder and activist actions increasingly focus on ESG topics such as climate change, pollution, diversity, cyber security and even CEO pay
- Elevating and identifying ESG risks through a business' risk registers and committees and making sure it is understood how they will play out in and out of the boardroom, is crucial

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According to law firm, Herbert Smith Freehills, there have been over 170 ESG regulatory measures since 2018 at the national and European Union (EU) level with Europe leading the way around the globe, accounting for around 65% of all ESG-related regulation. For example, the Non-Financial Reporting Directive has obligated companies to report on a wide variety of ESG-related metrics, while last year the European Commission published its final report on the EU taxonomy – a classification system, establishing a list of environmentally sustainable economic activities. Outside of Europe, the Institutional Shareholder Services recently announced it will adopt a similar standard based on the EU taxonomy. Ultimately, this changing landscape will influence how, and in which sectors, companies and funds invest, as they consider whether a particular asset fits within the taxonomy or ESG strategy, how they will report on it, and what shareholders and stakeholders will think.

As investment decisions are increasingly influenced by this new environment, so too will be the role of risk management and in particular that of the board of directors. Directors' duties in many jurisdictions are already under growing scrutiny and this will only deepen given tightening regulatory frameworks. Questions and clarity about who is responsible for ESG topics, such as climate change, on the company board will not just be a matter of "nice to have" but essential if the duties of directors are considered to be adequately fulfilled in future. Such topics need to be right at the heart of company decision-making.

"BAD NEWS" IN THE SPOTLIGHT

The directors and officers (D&O) insurance market has already seen some significant challenges in recent years – particularly regarding increased claims frequency and severity. One of the reasons for this has been a significant shift in this environment from traditional financial statement- or reporting-related litigation, such as bankruptcy or fraud, to so called "event-driven" or "bad news" litigation, which can often result in significant securities or derivative claims from shareholders, if the "bad news" causes a share price fall or a regulatory investigation.

“Increasingly, such incidents can involve ESG issues *(see graphic)*,” says **Shanil Williams, Global Head of Financial Lines at AGCS**. “And if an ESG issue is not handled or disclosed appropriately by the company or board, it can result in ‘bad news’ in their market, ‘bad news’ for the company share price and ‘bad news’ in the form of regulatory and legal action. ESG topics pose a significant D&O risk for companies and their insurers.

“Legislation is evolving. Regulators are becoming more active, as are many other stakeholders. Companies – and current and future D&O underwriters – need to be aware of ongoing global ESG matters, from activist investor campaigns to social justice protests or money laundering schemes in order to adequately assess potential perils and how they can manifest in terms of potential liability. There are a growing number of topics that boards need to stay on top of where we already see examples of litigation, investor, shareholder and activist actions and D&O claims.”

TOPICS TO WATCH

• **Climate Change Actions:** Although ESG represents a much broader topic than just climate change, incorporating issues such as social mobility, diversity, business and human rights and sustainable and social investment, understandably the climate change topic is very much at the forefront of people’s minds. Much of the litigation seen to date has been around disclosure – companies and boards failing to adequately disclose the material risks of climate change. For example, there have been a number of recent lawsuits in the US following wildfires where it is alleged companies did not disclose the changes in the environment that were leading to more wildfire activity, and, subsequently, how this could negatively impact the business. Companies’ boards of directors have a vital duty to ensure solid corporate climate responsibility with appropriate reporting and due diligence.

• Over the past year there has been a big uptick in **Board Diversity Litigation**, particularly in the US, with cases typically alleging there has been a failure in the fiduciary duties of directors given the inadequate level of diversity on the board or in management positions. A number of studies show diversity brings better risk management and financial performance to a board. Companies in the top quartile for gender, ethnic and cultural diversity on their executive team are 25% more likely to have above-average profitability of outperformance than companies in the fourth quartile[1], according to McKinsey & Company. This uptick in litigation started in California, where a number of technology companies such as Oracle and Facebook have faced claims. "That the composition and diversity of the board is adequate enough to effectively manage risk is an issue that is only going to expand in terms of importance and governance in future," says Williams.

• **Pollution and Environmental Disasters**: In the aftermath of events such as the collapse of a dam or an oil spill impacting an ecologically-sensitive area, the boards and directors of impacted companies are increasingly being questioned about whether they had adequate risk management processes in place to prevent such incidents from occurring and how aware they were of the possibility of them happening.

• **Greenwashing Claims:** Incidents of companies providing misleading information in order to present a more environmentally friendly and responsible public image have already been the subject of litigation in the US and crackdowns by regulators are imminent. In the UK, the Financial Conduct Authority has developed a set of principles to tackle concerns over false claims. The Task Force on Climate-Related Financial Disclosures, the Securities and Exchange Commission (SEC) in the US and European supervisors are also looking at this issue.

• **CEO Pay** is another hot topic, particularly for investors. Norway's $1trn sovereign fund – one of the world's largest – is just one that has developed active stewardship of management compensation proposals in the companies it invests in, amid concerns about opaque pay. At the same time, a growing number of companies are looking at linking CEO or director level remuneration to climate/ESG-related targets, such as greenhouse gas reduction.

• **Cyber security** is fast becoming one of the most important ESG-related topics, particularly in terms of the sustainability of a business. Determining the cyber resilience status of a company is increasingly important for investors, while assessment of potential cyber exposures should be an essential part of any M&A process, given the number of large data breaches and the possibility that an acquiring firm could be liable for incidents predating the merger. The 2018 Marriott breach, which resulted in a $20mn+ regulatory fine for the hotel group, was traced to an intrusion in 2014 at Starwood, a hotel group it acquired in 2016. "Cyber security is a big governance topic for companies – making sure it is understood at the board level and that cyber risk monitoring processes are in place," says Williams. "The main complaint from the investment community has been around transparency. It is hard to understand a company's cyber risks. And companies for various reasons have been slightly hesitant to provide enough transparency but the ones that do certainly see the benefit. The increasing focus on digitalization and remote working following the Covid-19 pandemic means this topic will only become more important."

Impact of new supply chain legislation around aiding and abetting violation of child labor law, and water management and biodiversity degradation strategies, as misuse comes under increasing scrutiny, are just a couple of other examples of ESG topics increasingly on the risk radar.

[1] McKinsey, Diversity Works: A Study On Why Inclusion Matters, May 19, 2020

BEST PRACTICE COMPLIANCE AND LIABILITY MITIGATION

A crisis represents the real test of governance. And for many companies the pandemic has proven to be a huge learning curve with the board having to be at the center of the company's crisis management response. One positive change to emerge is a recognition of the increasing need to monitor, manage and report on a wider range of potential risks than before, including non-financial topics, which could result in many companies being better positioned for the advent of new disclosure regimes around ESG risks.

"What we have learned from our own ESG experience is that you need a strong commitment at the management and board level," says **Michael Bruch, Global Head of Liability Risk Consulting/ESG at AGCS**. "Within Allianz, we have implemented our own ESG board, so that all the important group centers are really committed to sustainability and the ESG topic, including the setting of specific targets from top management down. Then it is about translating this into execution.

"ESG risk topics should be integrated into enterprise risk management and all relevant operational processes. What we are seeing in many of the industry sectors of our client community – and in particular the power and utilities sector which is heavily challenged by the transition of its own business model into a more green energy-related power supplier – is that ESG and sustainability is having a high impact on virtually all functions within the company."

Companies and their boards can benefit from conducting internal due diligence around their decision-making processes and determining any potential risk areas. For example, the prospect of climate change litigation risk increases the more there is a discrepancy between what a company does and says internally and what it does and says externally (even further to the extent to which any public statements or actions of a company might contravene a legally-binding framework). Engaging with ESG subject matters is crucial. It is important that ESG is not only on the board agenda a few times per year but that a company embeds sustainability topics and thinking into the whole organization. Beyond internal steering, it is also crucial for the board to acquire appropriate skills and understand the external requirements in order to be successful in the long-term.

"Elevating and identifying ESG risks through a business' risk registers and committees and making sure it is understood how they will play out in and out of the boardroom, is crucial," adds Williams. "Disclosure is not just about the various regimes coming in around the world but also about how you disclose to the wider community – employees, stakeholders and the media – the latter, in particular, can have a devastating impact on reputation."

NOT JUST ABOUT GOVERNANCE

ESG is not just about governance issues according to Bruch. From the insurer's perspective, there are also opportunities, such as helping organizations to improve their ESG capabilities, given Allianz's own initiatives and its experience in observing ESG best practice across many different industry sectors. At the same time, ESG information can also help to improve the underwriting process, to the benefit of insurers and companies.

"We are utilizing ESG data in our D&O insurance underwriting," explains Williams (as part of a partnership with investment and risk consultant, the Value Group). "We have statistically modeled a lot of ESG data points against claims and public litigation and we do see some predictive power there. From an insurer's point of view, conversations around ESG-related topics, in addition to financial topics, are becoming much more important."