ESG & Board of Directors

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For Board of Directors, things were simpler in the past. Their mission was clear: to maximize shareholder's wealth. They followed, particularly in the US, Friedman doctrine postulated by Prof. Milton Friedman of Chicago University in his famous essay in 1970 that "the social responsibility of business is to increase its profits".

Over time things have become more complicated and there have been many initiatives to broaden the purpose of business. The most significant development was in 2019, when the Business Round Table, the preeminent organization in the US adopted that Purpose of a corporation was to serve all its Stakeholders: Customers, Employees, suppliers, Communities and Shareholders. The mechanism for expressing corporate purpose evolved to include ESG (Environment, Social and Governance) considerations besides shareholder value creation.

The investment community also concluded that, over long term, companies with better ESG performance will produce better financial returns and trillions of dollars have been invested in companies with superior ESG performance. However, in the last one year, ESG investing in the US has become rather controversial and political issue. The Republican presidential candidates, particularly Ron DeSantis and Vivek Ramaswamy, have taken strong positions against ESG, linking it to the liberal Democratic Party agenda.

There are other valid criticisms of ESG approach: it's too broad, complex and covers too many factors. The best way forward is to unbundle and look at E, S and G factors separately. Also relevance and emphasis on various factors will vary country by country.

ESG approach, with all its complexity and flaws, is the best we have so far. Its main attraction that it broadens the purpose of a company, promotes stakeholder capitalism, focuses on Climate change issues, and makes business sector relevant to younger generation.

In India, the Companies Act 2014, mandated that companies must invest 2% of their profits on CSR - Corporate Social Responsibility projects overseen by CSR Subcommittee of Board of Directors. Companies also included Sustainability performance in their Annual Reports. SEBI has now mandated BRSR -Business Responsibility and Sustainability Reports for top 1000 companies. The BRSR framework includes most of ESG factors. The investors and lenders to Indian companies are paying increased attention to ESG performance of companies. Several Rating frameworks such as MSCI, are providing ESG Rating of companies. But there is more confusion than clarity on the approach Board of Directors should follow regarding ESG performance.

Following are some suggestions for Board of Directors to assist in understanding and improving ESG performance of their companies.

1. The first step is for the Board to discuss and develop a common understanding of ESG - Environmental, Social and Governance factors most relevant to their companies. While many of the factors will be common, the emphasis would be different depending on Industry. For example the Environmental challenges for Thermal Power, Oil and Gas, Steel and Cement industries will be very different from IT, Pharma, Financial Services industries.
2. Boards should consider and prioritize all relevant ESG factors. Environmental factors like Carbon Footprint including Thermal and Renewable power consumption, Energy efficiency, Air pollutant emissions, water consumption, effluents, etc. : Social factors including gender balance/diversity, equal opportunity, training and development, health and safety, R&D, Innovation, value to the customer, etc.: and Governance factors such as Composition and Skill set of Board of Directors, Board effectiveness, Compliance, corporate reputation, Board and Top management succession planning, should be carefully considered.
3. The Board should consider the internal view of all ESG factors as reported in the latest BRSR in the Annual Report as well as the Outside- in view as reflected in the ESG Rating of the Company by various agencies. It should also compare the ESG Rating of the company with its industry peers and identify gaps. The Board should also ascertain ESG concerns of its top investors and lenders.
4. Financial Services companies should, in addition to their own performance should also evaluate the ESG Ratings of companies in their portfolio, industry concentrations, and develop a weighed average portfolio ESG score.
5. The Management should develop, and present to the Board, a multiyear ESG Improvement Plan and Goals. Some actions will be low hanging fruits and some will require time and investment. If possible, companies should set time frame for Net Zero and industry leadership goals.
6. To provide closer oversight the Board should have a separate ESG subcommittee, or have this responsibility delegated to CSR Committee or Audit Committee. This Committee should monitor progress on ESG improvement Plan, industry comps as well as BRSR.
7. To drive the ESG agenda and BRSR Reporting the company should appoint a Chief ESG Executive at CXO level.
8. There should be ESG awareness training at various management levels with the company and ESG considerations should become part of corporate culture.

9. All major Capex proposals should include ESG considerations and impact.

10. The attainment of ESG Goals should become a part of performance evaluation of the Board, CEO and Top Management.