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ESG Now Podcast

"Does Your Board Need a Climate Superstar?"

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Bentley Kaplan

Hello, and welcome to the weekly edition of ESG Now, the show that explores how the environment our society and corporate governance affects, and are affected by, our economy. I'm Bentley Kaplan, your host for this episode.

I've had a few weeks away from the mic, so it's good to be back in the swing of things. And on this episode, ahead of 2024's proxy season, we are going to be talking about climate governance at big corporates. Because more and more, as climate change intensifies, shareholders and nomination committees might be tempted to bring on a new director; somebody with climate credentials.

And if you're a climate investor, having a voice in the boardroom to nudge the ship through growing climate risks and opportunities seems like a no-brainer. Or at the very least, you'd expect these new climate credentials would help a company to set climate targets, or bring its emissions down. Right? Well, don't be too hasty. Recent research from two of my colleagues might just surprise you. So, thanks for sticking around. Let's do this.

We've spoken about climate investing, climate data, and climate regulations on the show before. We've even spoken about climate governance at companies, a term that's gaining increasing traction. And that goes from things like, "say on climate proposals" to proxy showdowns at oil and gas giants, to decisions to carve out carbon-intensive subsidiaries.

But today, we are looking much more closely at a company's board, and how investors might think about that board's readiness to tackle the risks and opportunities that climate change brings. Whether that's from changing policy and regulations, or physical climate risks, or opportunities from low-carbon products or services.

It's a discussion that could very quickly get out of hand, so we're going to be very specific in narrowing things down. And to do that, I'm going to talk to Florian Sommer out of MSCI's London office.

Now, Florian, you worked with David Muirhead on this piece of research, where you guys looked at how the presence of a climate expert on a corporate board correlated with those companies setting climate targets, and then progressing towards them. Before we get into the slightly surprising results that you guys found, and their implications, maybe let's hit the most obvious question, right? What's the motivation to do this research in the first place?

Florian Sommer

This research is about how companies set up their decision-making to manage climate-related risks and opportunities. So effectively, climate governance. More and more investors are looking at this topic, both in terms of their portfolios, but also in terms of working with companies to improve their practices. So it's a big, current topic, and it's become more and more important, I think, for many investors in recent years.

Bentley Kaplan

OK, so you've got investors that are eyeing out this question of climate governance, or how prepared a company's board is to address the many vexing questions of climate change. But that's obviously a sprawling topic, and you've got to start somewhere sensible, right?

Florian Sommer

What we wanted to do in this paper is zone in on one of the key areas of climate governance, director expertise. So the question of whether the board has the right know-how, sufficient expertise, to deal with this quite complex question of climate change, and how it impacts company practices.

I view this as a key component of assessing climate governance. And the interesting thing is that there's actually so far, no generally accepted definition of what counts as climate-related expertise. So you could say there is a gap. And so that's part of what we wanted to fill.

But it's not just that. We also want to see how this question of expertise plays into changes in actual company practices. So basically, whether having climate experts on the board will help companies adopt and then implement climate targets.

Bentley Kaplan

So we've covered why you wanted to look at this research in the first place, but I'm sure you've got a long list of papers and analysis that you'd like to run in your research wish list. So why did this one get out the door now, specifically in late March, early April?

Florian Sommer

Well, that's because it's proxy season. You have shareholders around the world that will be casting their votes in board elections, in director elections, over the coming weeks and months. So in fact, deciding who should sit on these boards of listed companies, and effectively what the overall skills mix for directors should be.

And so that means, I think, now is the time for many investors and companies to think about exactly these kinds of issues of work composition, and what skills should be present on the board, and how this might potentially affect company practices. Generally, but also including in the area of climate change.

Bentley Kaplan

Right, got it. So as we head into this year's proxy season, investors that are focused on climate might be very interested in who is sitting on a company's board, and whether there are robust climate credentials among its directors. And maybe there's an implicit assumption that having a climate expert on a company's board is a decent safeguard, an assurance that someone's leaning over the boardroom table and making sure that climate risks and opportunities are being embedded into company strategy.

But of course, boardroom dynamics are not necessarily straightforward. So a good analyst is going to want to kick the tires that these assumptions are riding on, and in this case, to see what a climate-savvy director might mean for a company's climate strategy. So Florian, you and David looked at the Climate Action 100+'s list of focus companies.

As a mid-episode footnote. The Climate Action 100+ is an initiative formed by a bunch of global investors. The mission of the initiative is to, quote, "Ensure the world's largest corporate greenhouse gas emitters take necessary action on climate change." The Climate Action 100+ has put together a focus list of companies; the world's biggest corporate emitters that it has targeted for engagement. The list started at a hundred companies in 2017, but maybe, quite tellingly, has grown to 170 by the end of 2023. Here ends your mid-episode footnote.

So Florian, you and David looked at this list of companies because not only are they relatively intensive emitters, but they're also likely to be seeing decent levels of investor engagement. And then you took some of our in-house corporate governance data and climate data, and started assessing how the presence of a climate expert correlated with company attributes.

You hit a snag pretty early on in the process. There isn't actually a widely-endorsed definition of what a climate expert looks like when it comes to corporate governance. And like any good trailblazers you made your own way, setting up a framework as a starting point. So for our benefit, could you share a little bit on what sorts of things you were thinking about when defining this climate expert?

Florian Sommer

So we thought about some criteria. Things like being an executive who actually has to apply technical climate expertise in their role, or climate-related academics, for example, among other roles. Based on that, we said, well, who among these directors in the peer group is actually an expert?

Bentley Kaplan

So once you know who is a climate expert and who isn't, you can then take this list of focus companies from the Climate Action 100+ and split them into two buckets. So on one side, you've got companies that have a climate expert on their board. And on the other, companies that don't. And then you look at these two buckets of companies, and you compare them in terms of their climate targets, and sort of progress towards those targets. Which is where things went kind of upside down for a little bit. Take us through that.

Florian Sommer

The results, I think, are very interesting. And I think they're very interesting because they're counterintuitive. At a high level, you might expect that having experts on the board helps. Having an expert on the board might help the board, as a whole, understand these complex climate issues. And then, again, help the board as a whole drive the company to adopt climate targets, and then actually implement them.

But what we actually found is quite the opposite. Companies without experts did better than companies with experts, based on our analysis. The group of firms without experts had a higher rate of companies with credible climate targets. And this group without experts also had a higher share of firms that were actually on track with implementing all of their climate targets.

Bentley Kaplan

So that's a little odd, right? Do we then look at this result and say that not only do climate experts on the board not matter, but they actually seem to make things worse?

Florian Sommer

I don't think so, and I don't think our data actually shows that. What it does suggest to me is that if you care about how the company is performing on climate targets, you may want to look more widely at its broader governance in climate governance practices, and not just focus on whether there's one specific expert on the board.

Bentley Kaplan

So this is where things got really interesting for me. Because when I first read your analysis, admittedly over a pile of Easter eggs, I was sort of nodding along. Like, sure, let's give a company a director with climate expertise, and we are going to see a bump in more proactive climate strategy. Whether that's setting targets, or resting more heavily on renewable power, or looking to make supply chains more climate-resilient.

But as you say, what you found was kind of the opposite. And it's almost because you had this counterintuitive result, that it opened up things much more for discussion. Because had you seen something more intuitive, like climate experts on the board make for more climate-savvy companies, then it's quite tempting just to kind of publish and call it a day. So can you take us through the thought process of having the surprising outcome, and how that fits into your broader view of governance?

Florian Sommer

Yes, absolutely. So governance is a system, system of checks and balances that helps with good decision-making, good corporate decision-making. And I think if you look at our results, that point is just underlined. You have specific elements of this governance system which are very important; specific board skills, who's the chair, what are the committees, who owns the company?

But for me, the key element is actually how these different governance elements, how these different practices work together. So in the context of our research, what the results mean for me is, it's not just about looking at one specific aspect of climate governance, but it's rather about identifying the broader group of practices that, together, then help you analyze this question of how climate-relevant decisions are made at the company, and whether these decisions are made in an effective way.

Bentley Kaplan

Okay, so I do love that thinking. But if we can take things out of the philosophical and more into the day-to-day for investors, what sorts of questions might they be asking? What areas could they be thinking about as they actually move to engage with companies, or analyze their portfolios through a climate governance lens?

Florian Sommer

It's about, yes, climate expertise on the board. It's about who has this expertise? Is the expert and executive or non-executive? There's some data in our research that actually suggests that if you have an executive who is the expert, that correlates with better climate performance compared to companies that have non-executive experts.

It's also about what other skills are present on the board. Is there financial expertise? Is there industry expertise on the board? That's important. It's also about which committees you have. Do you have a sustainability committee? Do you have an environmental committee that really helps the board focus on these complex topics?

And I think it's also about incentives, executive pay policies. So if you take all this together, I think you start to get a better picture of climate governance. And then you can say, well, based on that, how do these decision-making structures impact actual climate practices? And in that sense, if you think about it that way, our findings actually, I think, make a lot of sense.

And that's because, to me, corporate governance is a system. It's a system of checks and balances. So you have to look at the wider system, how the different individual practices work together, to see whether that system is effective.

Bentley Kaplan

Right. So expecting a solo climate expert on your board to be the cure-all that suddenly sees a company releasing a cutting-edge climate strategy for shedding emissions might be a bit of a stretch. As Florian talked us through it, comprehensive climate governance is much broader than that. And although it also includes director expertise, it extends to things like “say on climate” proposals, executive pay structures, committee duties, and much more than that.

And it's all these different things interacting together that gives you the collective. Corporate governance is very much about how all these different components interact, and climate governance is no different. And there are some caveats to be sure. Companies are rapidly evolving their climate targets and their efforts, and potential limitations in what those companies are reporting publicly can make it difficult to assess exactly what's going on in a boardroom.

It's also telling that there is no accepted definition of what climate expertise actually is, or who should be defining it. But even with these caveats, these results will be food for thought as investors and shareholders specifically head into the 2024 proxy season.

And that is it for the week. A massive thanks to Florian for his take on the news with an ESG twist. Thank you very much for tuning in. I have no doubt that you've enjoyed listening to episodes from our new hosts, Margarita and Gabriela, who are killing it, by the way. So look out for them in some upcoming episodes. And with all of this new talent elbowing me out the studio, it does make weeks like this one just a little bit more precious for me. And speaking of precious, keep an extra ear out over the next couple of weeks, because we're planning yet another host debut on ESG Now.

If you are enjoying our content and you want to help share it with colleagues and friends, please do. Or just rate and review the show on your platform of choice. All of that helps us to reach a wider audience, and to make the world of ESG and sustainable investing just a little bit clearer and accessible. Thanks again. And until next time, take care of yourself and those around you.

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