



SYSTEMS RULE:

How Board Governance Can Drive
Sustainability Performance





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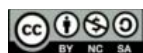
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About Us

Ceres is a sustainability nonprofit organization working with the most influential investors and companies to build leadership and drive solutions throughout the economy. Through powerful networks and advocacy, Ceres tackles the world's biggest sustainability challenges, including climate change, water scarcity and pollution, and human rights abuses. For more information, visit www.ceres.org.

At **KKS**, we advise leading organizations on bold and effective strategies that pave the way to a sustainable society. Applying our unique, research-backed approach, we work with corporations, foundations, NGOs and investors on sustainable strategies that deliver lasting impact. For more information, visit www.kksadvisors.com.



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Foreword



Mindy Lubber
President and CEO,
Ceres

Climate change, water scarcity, human rights abuses, and other sustainability challenges, are increasingly hitting the corporate balance sheet. While much has been written on the role of management in addressing these risks, the role of the corporate board is critical to this conversation.

When any issue—including sustainability—becomes material to corporate financial performance, boards have a responsibility to act. Corporate boards must treat environmental and social factors no differently than any other business disruptor, such as cybersecurity or trade wars.

The question is: how can boards use existing corporate governance structures to **effectively** oversee material sustainability risks? How can board oversight of climate change, water scarcity and human rights abuses lead to improved performance?

Our new report, *Systems Rule: How Board Governance Can Drive Sustainability Performance*, provides insights on this important question. The report analyzes how boards of the world's largest companies oversee sustainability. Specifically, we examined board systems that have been a particular focus of the investor community, including whether corporate boards have a formal mandate to oversee sustainability, whether they have recruited directors with sustainability expertise, and whether they have linked executive compensation to sustainability priorities.

The report's findings confirm our theory of change: companies that have strong board systems to oversee sustainability are well positioned for strong performance. In fact, companies that approach board governance in an integrated manner—including the right mandates, the right people and the right incentives for sustainability—demonstrate the strongest sustainability performance.

This is further reinforced by similar findings from Ceres' *TURNING POINT: Corporate Progress on the Ceres Roadmap for Sustainability*, which evaluated more than 600 U.S. companies and found that robust governance leads to strong performance across key sustainability expectations.

However, both reports also find that the majority of companies—in both global and U.S. universes—have board governance systems that are largely piecemeal.

We need companies, corporate boards and investors to take action and build effective board systems for sustainability. The resiliency of our economy, communities and companies depend on it.



Foreword



George Serafeim
Senior Partner
and Co-founder
KKS Advisors

We are living in an era of faster and fundamental changes. The pace of social change and environmental impacts is accelerating, together with expectations and demands on corporations and their boards. The need to align products and business processes with a low carbon future and to create inclusive organizations for all employees independent of gender or race are just two examples of top of mind issues for business leaders. But many board of directors seem to be reactive to this changing operating environment rather than proactive. There is a lack of best practice when it comes to establishing the governance system that would allow a company to properly measure, drive and communicate a company's environmental and social impacts and how those affect the company's ability to create value.

Almost a decade ago myself and co-authors Professors Ioannis Ioannou and Robert Eccles wrote the paper "The impact of corporate sustainability on organizational processes and performance" where we showed that a group of firms that exhibited a commitment to sustainability outperformed over the next 18 years a carefully matched control group of competitors that had in the beginning of the sample same profitability, capital structure, market valuation, and size. In our results we found that one of the distinguishing characteristics of these firms was strong corporate governance systems. We found that the board of directors had formal responsibility for sustainability issues and that executive compensation was linked to key sustainability metrics. Our evidence showed that the role of the board in driving sustainability and as a result financial performance is critical.

Since then we have seen the integration of sustainability issues both in corporate strategy and investment strategies. The same needs to happen in boardrooms. Rather than treating sustainability issues as the domain of a separate board committee, directors need to start diffusing responsibilities for the different aspects of sustainability in the different board committees and to seek a systems-level view of corporate governance. The quality of sustainability metrics needs to be part of the audit committee. The incorporation of sustainability metrics in executive compensation is the responsibility of the compensation committee. And the governance committee needs to make sure that directors have the skills and the board the composition to govern a company's performance on sustainability issues. This was the spirit of the 'Integrated Governance' model proposed a few years ago by myself and Sakis Kotsantonis, one of the authors of this new report. This report should serve as a useful resource for companies that seek to create a high performing board supervising the co-creation of financial and sustainability performance.

Executive Summary



Today, many of the world's largest companies are starting to integrate sustainability into their board governance systems, but too often board systems are still rudimentary and do not focus on material issues. In many cases, board governance for sustainability does not drive performance. In other words, it is ineffective.

However, companies with the right board governance systems, including **formal board mandates for sustainability, board expertise on sustainability, and executive compensation linked to sustainability**, are more likely to have established strong sustainability commitments and are better positioned to deliver sustainability performance.

These are some of the main findings of this report, based on our research of 475 of the world's largest companies of the Forbes Global 2000. Through an analysis of board governance practices and performance data, we examined the extent to which the largest companies in the world had implemented these three key board governance systems for sustainability and if they did so, the impact that it had.

We found that while most boards have taken steps to oversee sustainability, their approaches are still largely piecemeal.

- While most large companies state that they oversee sustainability at the board level, only a minority have formal mandates and demonstrate board-management engagement on sustainability.
- Most boards do not have directors with demonstrable sustainability expertise.
- A third of the companies analyzed state that they link executive compensation to sustainability, but most do not give details on which specific goals are incentivized.

At the same time, our analysis showed positive relationships between companies whose boards incorporated the right systems and sustainability outcomes.

- Companies that were able to demonstrate stronger board governance systems were more likely to have established sustainability commitments.

- Companies that showed the best performance on sustainability were more likely to have established all three board governance systems that our report examined.
- Board governance systems reinforce each other, which could help trigger virtuous cycles of improvement.

The message is clear. Integrating sustainability across board governance systems is key to unlocking better sustainability performance. Integrating formal mandates, strengthening board expertise and incentivizing top executives to deliver on sustainability goals will make a difference.

Our goal is to provide key insights into the elements that lead to *effective* board governance for sustainability to help investors, companies and advocates decide how to focus their efforts.

Recommendations:

- **Make board governance systems holistic.** The companies that perform best on sustainability issues are those that have incorporated mandates, expertise and incentives for sustainability that reinforce one another.
- **Exercise sustainability oversight with an eye towards performance improvements.** The board can play an important role in asking management the right questions and encouraging executives to identify the right material issues for corporate performance, as well as setting goals for these priorities. Financial incentives can also be used to spur performance.
- **Orient board governance systems towards performance on material issues.** The strongest performing companies don't just have the right board governance systems in place, they also link them to specific sustainability issues that are material to corporate performance.
- **Provide more detailed disclosure about board governance systems.** More detailed disclosure, including details on the material issues that the board prioritizes and how it addresses those priorities, can spur further sustainability commitments and improvements.



Introduction

For years, investors and sustainability advocates have encouraged companies to adopt robust governance systems for sustainability performance, with the role of the board coming under particular focus.

The theory was straightforward: A company that was managed well for sustainability was a company that performed well for sustainability.

But to what extent does this theory hold true? Do robust board governance systems for sustainability actually lead to improvements in sustainability performance?

Since 2014, Ceres continues to examine the notion of **effective** board governance, analyzing the systems of board governance that could lead to demonstrable environmental and social performance impacts.¹ Our work, based on the experiences of corporate directors, executives and investors, resulted in practical recommendations of leading practices that companies should adopt.

Building effective boards for sustainability

Ceres' thought leadership on how to build effective boards for sustainability is highlighted in two flagship reports. *View from the top: How corporate boards engage on sustainability performance* identifies strategies for integrating sustainability into board governance systems and board actions. *Lead From the Top: Building Sustainability Competence On Corporate Boards* builds on this foundation to describe the skills and experience needed by board members to effectively oversee sustainability risks and opportunities.

The business case for sustainability

Roughly 90 percent of studies find a positive relationship between ESG performance and corporate financial performance. Also, the positive ESG impact on corporate financial performance appears stable over time.³ According to 2017 research by Bank of America Merrill Lynch, ESG attributes are a better signal of future earnings volatility than any other measure.⁴ Sustainability indices perform as well or better than traditional benchmarks. For example, the MSCI Emerging Markets ESG Leaders Index, comprised of companies with high environmental, social and governance scores, has outperformed the benchmark since 2009. In addition, returns have been consistently higher in environmental technology, low-emissions and 'green' stocks.⁵ Integrating sustainability into governance practices can help boost investor confidence.

Building on this foundation, this report looks at the notion of effectiveness based on the board governance practices and performance data of the world's largest companies. In particular, we examined the following questions:

- What board governance systems do these large companies have in place to oversee sustainability?
- Are these systems robust?
- Can these systems be linked to sustainability performance improvements?

The report will be useful to investors, companies and advocates focused on sustainability governance systems and performance as they decide how to focus their efforts.

Ceres Roadmap for Sustainability

Ceres first explored the idea of "governance for sustainability" in the *Ceres Roadmap for Sustainability*, a report released in 2010 outlining various key sustainability metrics related to governance, stakeholder engagement, disclosure and performance. Since then, Ceres research has continued to offer guidance on establishing the important link between corporate governance and sustainability.

In February 2018, Ceres released its third assessment of more than 600 of the largest publicly traded companies in the United States and their progress against the expectations outlined in the *Ceres Roadmap for Sustainability*. The findings of *TURNING POINT: Corporate Progress on the Ceres Roadmap for Sustainability* show that strong sustainability governance leads to stronger performance across key sustainability priorities.



Why board governance for sustainability is important

ESG disclosure. Climate competent boards. Sustainability strategies. This is the language of investors today, from BlackRock and State Street Global Advisors, two of the world's largest asset managers, to Norway's \$1 trillion sovereign wealth fund and California's biggest public pension funds.

The reason is clear. Sustainability challenges, including climate change, water scarcity and inequality, are impacting the corporate bottom line. And the forces behind these sustainability risks and opportunities, from population growth to resource scarcity, are only going to keep intensifying. This means that directors, who are ultimately responsible for the corporate governance of their companies, are increasingly expected to take on a new role of providing formal oversight for corporate strategy and performance of material sustainability issues.

The corporate governance system—the rules, practices and processes that underpin a company and that give it shape and direction—can support corporate boards as they help the companies they oversee navigate changing conditions that can impact value creation. By integrating sustainability considerations into this system, directors position their companies for long-term resilient performance.

Why should boards oversee sustainability?

- **Sustainability risks affect the world economy.** In 2018, the World Economic Forum's list of the top 10 global risks impacting countries and industries included extreme weather events, natural disasters and failure of climate-change mitigation and adaptation.²
- **Sustainability is linked to financial performance.** Wall Street research, university studies, market indices and other reports overwhelmingly show that sustainability impacts corporate financial performance. In fact, in most cases, companies that are strong performers on sustainability typically outperform their peers on a range of financial metrics.
- **Shareholders expect action on sustainability.** The world's largest institutional investors and pension funds are increasing the pressure on businesses to integrate sustainability into their corporate governance systems. In 2017, shareholders in the U.S. filed far more resolutions about environmental and social issues than in the previous year (430 compared to 360).⁶ In 2018, Larry Fink, chief executive of BlackRock—the world's biggest institutional investor—issued a landmark letter to CEOs stating that BlackRock expects corporations to manage environmental, social and governance issues and that the role of the board is critical to achieving sustainable growth.⁷
- **Regulatory pressures require companies to evolve or be left behind.** Global regulators are tackling sustainability challenges by introducing more stringent requirements to address environmental and social issues. For instance, between 1997 and 2017, the number of climate-change relevant laws worldwide increased by a factor of 20.⁸ We are seeing similar trends on regulations covering issues from biodiversity protections to human rights.
- **Sustainability belongs on the board's agenda.** A key part of the board's fiduciary responsibility is the "duty of care" that requires directors to be adequately informed of issues that are material, or relevant, to the business prior to making decisions. Where sustainability is material, boards have a fiduciary duty to act.⁹



What board governance practices are most critical to move the needle on sustainability?

While corporate boards can affect corporate sustainability performance in a number of ways, this report focuses on the following systems, which have been the focus of investor attention in recent years:

FORMAL MANDATE



Formal board mandates for sustainability

What we examined: Whether 1) boards embed sustainability oversight at the board committee level through charter incorporation and/or 2) companies disclose whether boards and management discuss sustainability during board meetings.

Why this is important: When sustainability issues are material to a company, making sustainability a formal and explicit board priority within a board committee charter ensures that key issues are discussed systematically and in depth. With risk oversight becoming an increasingly prominent issue for the board,¹⁰ material sustainability risks must be among the key business risks that boards regularly consider. It is particularly important as such risks can potentially impact a company's profitability, success and sometimes survival.

SUSTAINABILITY EXPERTISE



Board expertise for sustainability

What we examined: If director biographies demonstrate background in or exposure to sustainability issues.

Why this is important: Corporate boards with the relevant skills and experience to oversee sustainability issues will be more effective at identifying and responding to risks and opportunities. The expertise of the board should correspond to the sustainability issues that are relevant to the company.

EXECUTIVE COMPENSATION



Executive compensation linked to sustainability

What we examined: If companies disclose linkages between executive compensation and sustainability priorities.

Why this is important: Compensation is one of the most potent levers the board can use to incentivize management to act on sustainability. By aligning executive incentives toward sustainability priorities and goals, boards are able to reward the right behavior and spur performance.



Report focus and approach

In developing this report, we analyzed the public disclosures of 475 of the largest companies from the Forbes Global 2000, an annual listing of the largest publicly listed companies in the world. This list was selected to provide a global snapshot of the governance for sustainability systems of the world's largest public companies. Vigeo Eiris, an independent provider of global environmental, social and governance (ESG) research and services, compiled the data that is the foundation of our research. The dataset covered three aspects of board governance systems—formal mandates for sustainability, director expertise in sustainability, and executive compensation linked to sustainability. Each aspect was examined using one or two indicators, with associated quality scores. To investigate the effect of sustainability governance practices on sustainability performance, we assessed whether or not a company had made sustainability commitments, and their overarching company sustainability scores, also provided by Vigeo Eiris. For a more detailed explanation of our methodology, see the appendix.

It is important to note that our analysis is based on a data snapshot of a single moment in time. The time lag between the creation of these systems and the impact on corporate performance has not been captured. To get a deeper understanding of this topic, it will be important to map corporate systems and performance over a range of years.



How do the world's large global companies integrate sustainability into board governance systems?

1

Do large company boards establish formal board mandates for sustainability?

Most large companies state that they oversee sustainability at the board level in some way, though only a minority demonstrate robust oversight

FORMAL MANDATE



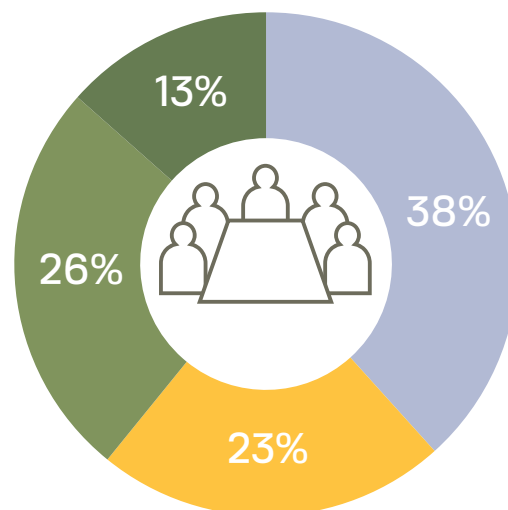
- Responsibility for sustainability issues at the board level
- Review sustainability issues at board meetings

Sixty-two percent of the companies we analyzed state that they have some form of oversight of sustainability at the board level. However, only 13 percent show truly robust oversight practices, meaning there is both a formal board mandate for sustainability (either through a dedicated sustainability committee or through the inclusion of sustainability in another board committee's charter) **and** the board receives regular reports on sustainability from management. This combination of both a formal board mandate with evidence of board-management engagement is important to demonstrate that sustainability oversight exists in more than name only, and is part of board discussions.

On the other hand, 38 percent of companies still have no discernable board practices in place for sustainability oversight.

Percentage of companies with responsibility for sustainability at the board level

- No responsibility at board level, or no disclosure of this information
- No committee with formal responsibility, but the board receives regular reports on sustainability
- Yes, has a dedicated committee for sustainability oversight or sustainability is included in the charter of another committee
- Yes, has a dedicated committee for sustainability oversight or sustainability is included in the charter of another committee, and the board receives regular management reports on sustainability





Leading practice: Strong board mandate for sustainability

At **Iberdrola**, the Corporate Social Responsibility Committee is responsible for advising the board on the “Mission, Vision and Values” of Iberdrola.¹¹ The committee is charged with a number of functions such as reviewing Social Responsibility Policies and annual reporting, evaluating stakeholder relations, overseeing the company’s inclusion in international sustainability indices, and advising the full board on the latest sustainability trends and measurement tools. In 2017, management executives and external experts interacted with the committee on an ongoing basis to discuss key sustainability topics, with extra one-off meetings conducted for additional topics.

Nike’s Corporate Responsibility and Sustainability Committee is mandated to work with management on the integration of sustainability into Nike’s business. Meetings are staffed by the company’s Chief Sustainability Officer and the Chief Operating Officer and typically include discussions of key sustainability issues as they relate to business functions and progress against those issues. Executives regularly appear before the committee to discuss how sustainability and business strategies are aligned and how this is reflected in the work of the teams that they lead.¹²

Boards are responsible for overseeing material priorities. The board can work with management to assess whether sustainability issues are material priorities by:

- having management identify specific environmental and social priorities for the company,
- investigating the connections between sustainability priorities and corporate risk and revenue and
- emphasizing long-term performance.¹³

Boards have many resources they can consider when determining sustainability priorities. In 2018, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and the World Business Council for Sustainable Development (WBCSD) released draft guidance for companies to navigate emerging environmental, social and governance-related risks by integrating them into enterprise risk management governance and processes.¹⁴ Many companies run processes to identify key issues for their sustainability reports, which could also provide useful input.

After identifying material sustainability issues, boards need to determine the best structure for formalizing oversight responsibilities. Three common options include:

- developing a stand-alone committee to oversee sustainability;
- including material sustainability issues within an existing committee and
- determining how the full board will deliberate and make decisions on sustainability priorities.



Dedicated board committees are the most common board system for sustainability

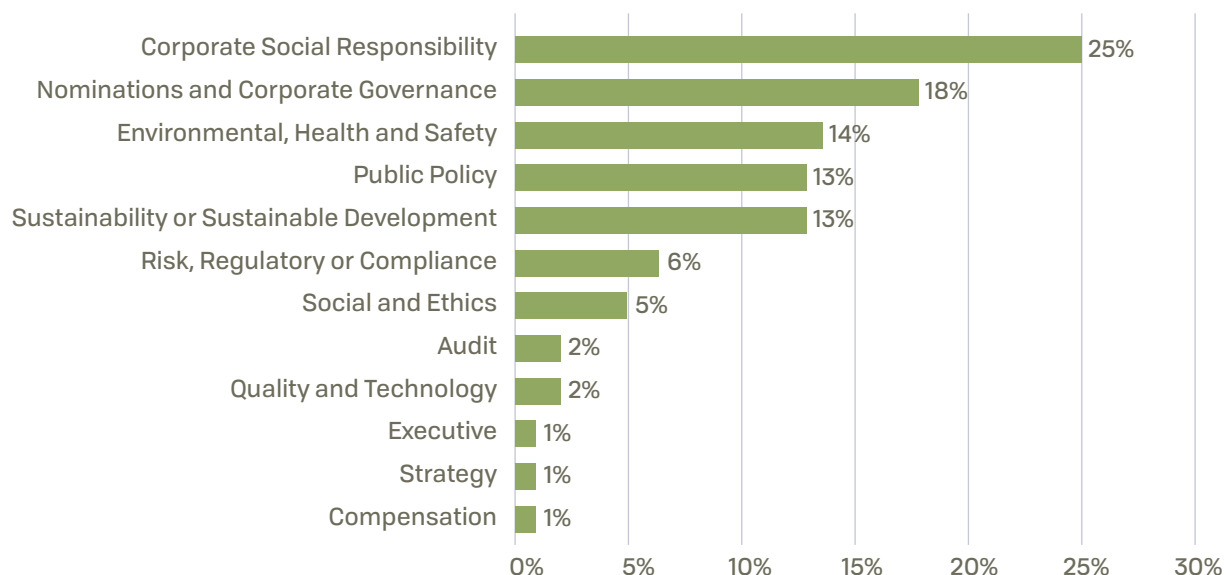
Companies adopt different strategies for integrating formal mandates for sustainability at the board level. There is no “one size fits all” solution and each creates challenges that companies need to keep in mind.

The most common approach is to create a committee dedicated to overseeing sustainability. Around 25 percent of companies with formal board mandates for sustainability have a corporate social responsibility committee, 13 percent have a sustainability or sustainable development committee, 14 percent have an environmental, health and safety committee, and 5 percent have a social and ethics committee. A dedicated committee can underscore how important sustainability issues are to the company and ensure thoughtful deliberation of its business implications. However, a separate committee could lead to isolated and separate discussions of sustainability.

An alternative approach is to include sustainability in existing board committees, such as the risk or audit committee which would allow for integration into regular board discussions. For example, 18 percent of companies include sustainability under the nominations and corporate governance committee (or similarly titled). This approach has its own challenges. Sustainability may be overshadowed when it is addressed alongside traditional business matters.

No matter where sustainability is institutionalized on the board, it is important that the impacts of material environmental and social issues on business strategy, risk and executive compensation are discussed. Sustainability issues that rise to the level of board discussion hold significant risk and opportunity for the company and need to be integrated into board committees that make decisions on strategy, risk, and incentive structures.

Which board committee has responsibility for sustainability?





Leading practice: Sustainability mandates across multiple committees

Aviva’s Governance Committee oversees the company’s responsible and sustainable business strategy and the policies that underpin it.¹⁵ The committee is responsible for reviewing progress against corporate responsibility, environment and climate change, in addition to reviewing related risk exposures.¹⁶ The board risk committee works with the governance committee to ensure that these risks are properly considered.¹⁷ The risk committee has identified climate change as an emerging risk, ensuring that the issue is regularly reviewed, and the potential long-term impacts evaluated for the business.¹⁸

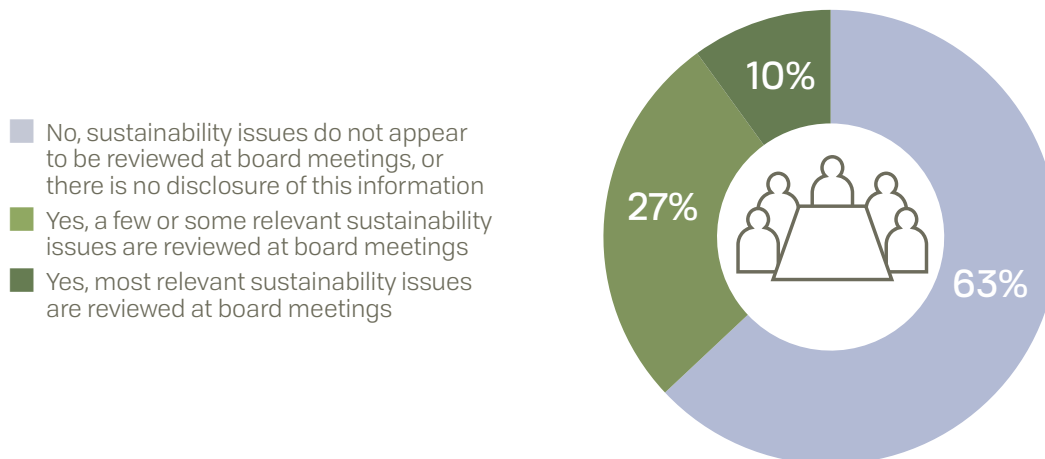
While most companies with formal board mandates seem to discuss relevant sustainability issues, the scope of issues being addressed remains limited

Assigning responsibility for sustainability at the board level appears to be an effective way of ensuring that sustainability issues are adequately discussed during board meetings. Our data show that companies with formal systems of board oversight are more likely to discuss material sustainability issues at board meetings.¹⁹ When formal mandates do not appear to exist, there is also very little evidence that boards discuss sustainability issues.

However, the scope of the issues being discussed by boards remains limited. Only 10 percent of companies disclose that they review most of the sustainability issues that are material to their business. For the most part, companies do not disclose issues that their board prioritizes and key decisions made.

More detail on board sustainability priorities and decision making could help investors and other stakeholders better understand how boards are making decisions on sustainability risks and opportunities.²⁰

Percentage of companies that review sustainability issues at board meetings





Resource: *Recommended disclosures on climate risks and opportunities*

In 2017, the Task Force on Climate-Related Disclosure (TCFD) issued a guidance report to help businesses disclose information about climate-related risks and opportunities.²¹

The report recommends that companies disclose information in four core areas:

Governance: The board’s oversight of climate-related risks and opportunities and the role of management

Strategy: Climate-related risks and opportunities and their potential impact on the business, strategy, and financial planning under different climate scenarios

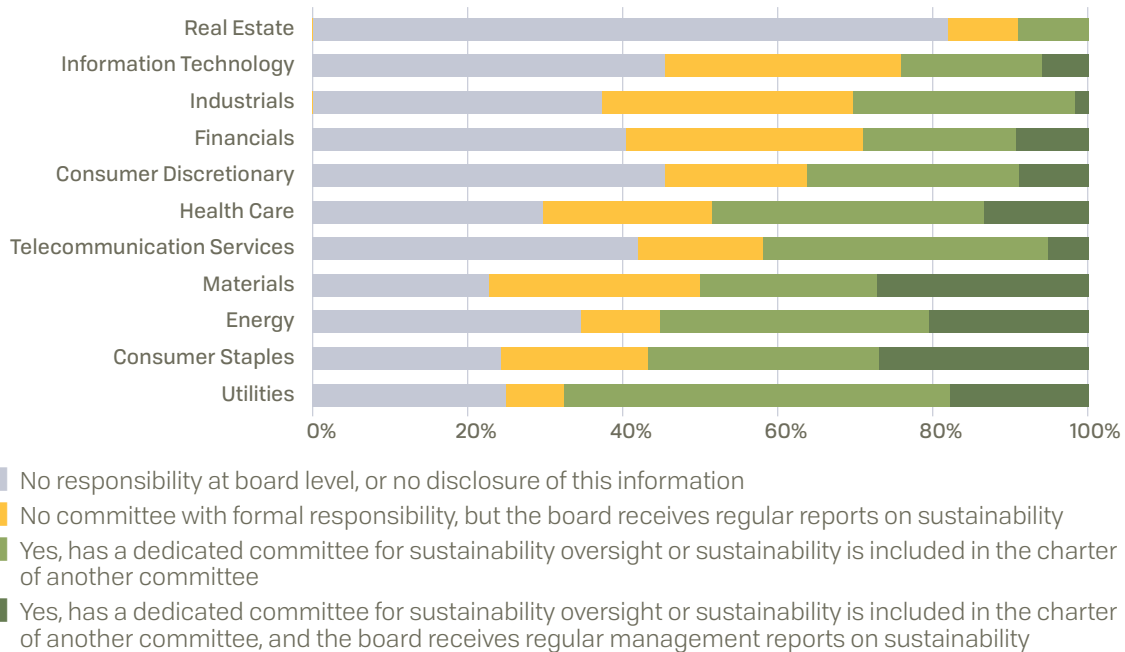
Risk Management: The processes used to identify, assess and manage climate-related risks and how these are integrated into overall risk management

Metrics and Targets: The metrics used to assess risks and opportunities, greenhouse gas emissions specifically, and targets used to assess performance.

Sectors where the materiality of sustainability is well established demonstrate higher board oversight of sustainability

The energy, utilities and consumer staples sectors have the most number of companies with formal mandates for sustainability.²² The strong performance of heavy industries, including energy and utilities, is likely due to the sector’s high exposure to environmental and social risks and stringent regulatory requirements. For the consumer staples sector, reputational risk, such as the increasing attention on human rights abuses in the apparel supply chain, may be the driving force. Research shows that companies typically scrutinized for negative externalities are more likely to have committees focused on corporate responsibility or sustainability.²³

Percentage of companies per sector with responsibility for sustainability at the board level





2 Do large company boards include directors with sustainability expertise?

Most boards do not have directors with demonstrated expertise in sustainability

SUSTAINABILITY EXPERTISE



- Board member with demonstrated sustainability expertise
- Diversity of the skills and background of the board

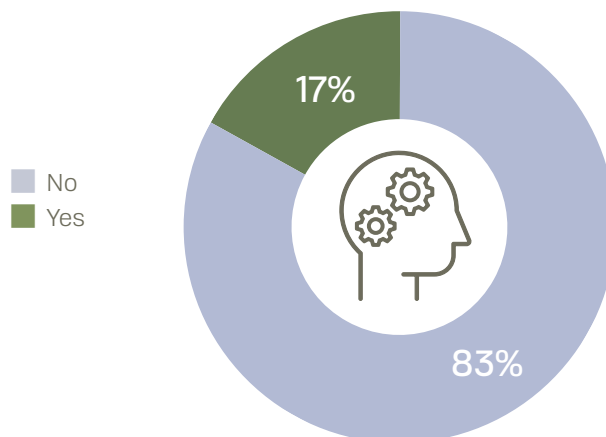
Boards of large global companies have work to do. While 39 percent of companies have formal board mandates for sustainability, just 17 percent have at least one director with demonstrated expertise or experience in sustainability issues. The results suggest that most boards may not have the right people who can exercise informed oversight on the sustainability issues that are critical to the business. Without directors with the proper expertise, boards will not possess the collective skillset and background to examine the impacts of complex environmental and social issues on corporate strategy, risk and resilience.

How many directors with sustainability expertise are needed before any change can be expected? While one corporate director with sustainability expertise is better than none, corporate boards should reach a “critical mass” to make a real difference in board culture, dynamics and decision making. Additionally, certain individuals, such as the CEO, may play

a pivotal role with boards, as Unilever CEO Paul Polman wrote in 2017, any company attempting to implement a sustainable business model must have a CEO that leads the transition.²⁴

Ultimately, having one or more directors with sustainability expertise is just the first step in driving thoughtful decision making. The goal for companies should be to create a board that is sustainability-competent as a whole and can engage thoughtfully on material social, environmental and governance issues as one cohesive deliberative body.²⁵ For this, in addition to recruiting directors with the right expertise, companies should educate the entire board on material sustainability issues and find opportunities for board dialogue with stakeholders and shareholders.

Do large company boards have at least one director with demonstrated expertise in sustainability?





Resource: *How to build expertise for sustainability at the board level*

Ceres' report *Lead from the Top: Building Sustainability Competence on Corporate Boards*²⁶ identifies a number of steps to integrate sustainability into the board nominating process:

- Create regular opportunities to recruit new directors with relevant sustainability expertise onto corporate boards;
- Incorporate material sustainability issues into board skills matrix when recruiting potential candidates;
- Find directors that can make the connections between environmental and social issues and the business context;
- Identify directors who represent key stakeholder groups relevant to a company's sustainability impacts; and
- Recruit candidates representing a diversity of backgrounds and skills to improve decision-making.



Leading practice: *Sustainability expertise on the board*

Danone's board members demonstrated a range of relevant sustainability expertise in April 2018. CEO Emmanuel Faber's previous background included social responsibility and innovation. Independent Director Gaëlle Olivier is the former Head of Communication and Corporate Responsibility of the AXA group. Independent Director Jean-Michel Sévérino is a former member of UN working group on sustainable development and has extensive experience on environmental and development topics from his work for the French Development Agency AfD.²⁷ Danone has also established an advisory board for external experts to provide governance advice around core sustainability topics.



Leading practice: *Sustainability as a board qualification*

Prudential Financial assesses directors against a skills matrix that includes sustainability criteria and discloses the results in the annual Proxy Statement.²⁸ According to the assessment, "environmental/sustainability/corporate responsibility experience strengthens the Board's oversight and assures that strategic business imperatives and long-term value creation for shareholders are achieved within a responsible, sustainable business model." In 2017, four directors out of twelve were identified as bringing this experience.

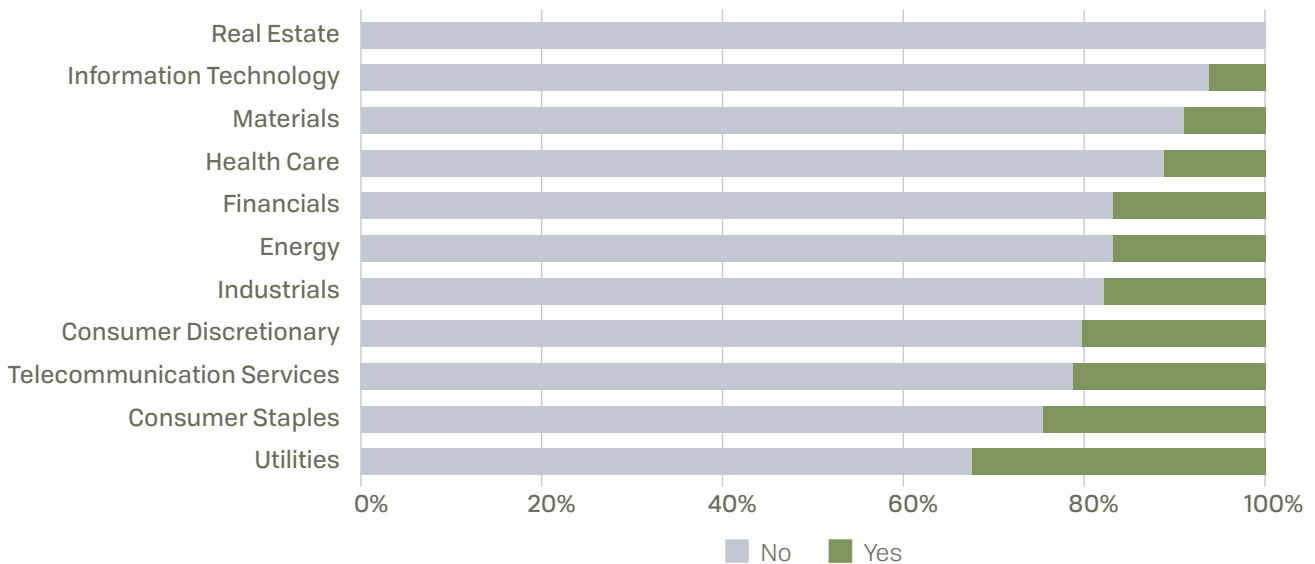


Heavily scrutinized sectors have the greatest number of directors with expertise in sustainability

Companies in the utility sector have the most board members with demonstrated sustainability background (more than 32 percent of companies have at least one board member with such experience). Backgrounds represented include expertise in climate change, environmental regulation and compliance, employee health and safety and renewable energy. Since many of these issues pose regulatory risk for this industry, they are prominent topics of interest at the board level.²⁹

Consumer Staples boards also perform well, which may be due to consumer pressure and public scrutiny over products. Food safety, nutrition, water and sanitation are among key concerns for this sector, along with social and environmental impacts in the supply chain.³⁰ These issues are currently reflected in the board make-up of companies such as Nestlé, whose Chairman of the board, Paul Bulcke, is also co-chairman of the 2030 Water Resources Group, which has the mission of helping countries achieve water security, in line with the United Nations Sustainable Development Goals.^{31,32}

Sector analysis: Does the board have at least one member with demonstrated expertise on sustainability issues





3

Do boards link executive pay to sustainability goals?

While a third of large companies link executive compensation to sustainability, the focus of incentives is unclear

EXECUTIVE COMPENSATION



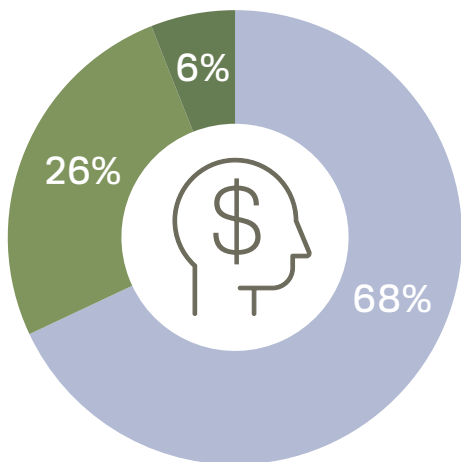
→ Link executive compensation to sustainability performance

Some 32 percent of large companies note that they link executive compensation to sustainability performance. Our data indicate that companies with more formal board mandates for sustainability are more likely to link executive compensation to sustainability goals, suggesting that formal oversight provides a structure that boards can leverage to hold management accountable for sustainability performance.³³

It is worth noting, though, that only 6 percent of companies tie executive compensation to sustainability, link them to targets and disclose details of the sustainability targets in question. In the absence of such disclosure, stakeholders and shareholders are not informed about what kind of performance is being incentivized. Additionally, the range of sustainability metrics that companies link to compensation is narrow. It is common practice, for instance for just one sustainability metric to be linked

to pay. To give decision-useful insight to stakeholders, companies should disclose the issues that are the focus of executive compensation, the proportion of pay at risk, and whether bonuses are linked to short or long-term incentive structures.

Do companies link executive compensation to sustainability performance?



- No
- Yes, but do not disclose targets
- Yes and communicate actual targets



Leading practice:
Executive compensation linked to sustainability

L’Oreal considers sustainability objectives when it comes to determining the variable remuneration and performance targets of senior executives. Chairman and CEO Jean-Paul Agon’s annual variable remuneration is based on hitting the organization’s 2020 sustainability targets of a 60 percent decrease in carbon emissions, water consumption and waste. In 2016, the beauty products conglomerate announced it would start linking the bonuses of brand managers and country managers to environmental targets.



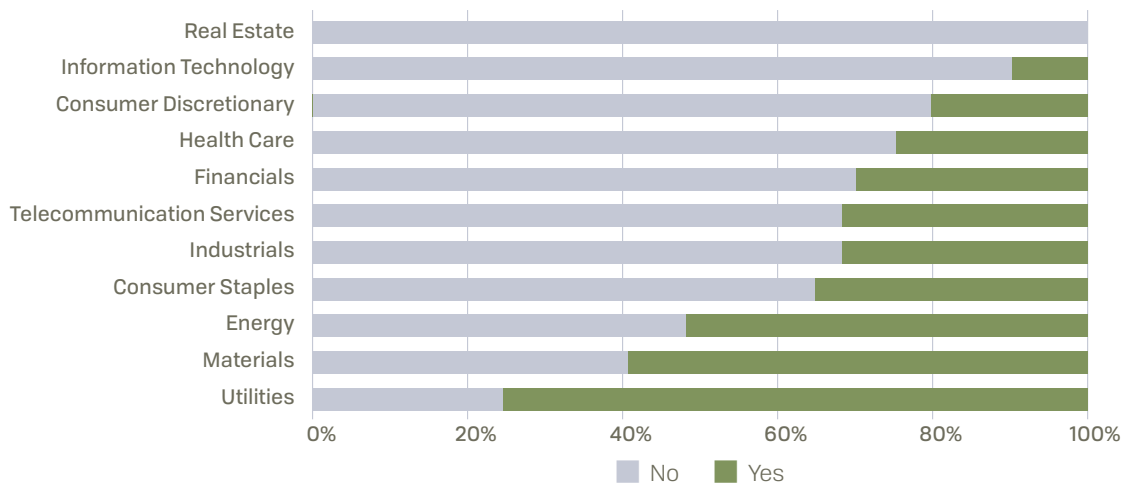
Leading practice: Sustainability performance incentives for executives and top managers

At **BNP Paribas**, remuneration is linked to the bank’s social commitments and integrates assessment criteria on sustainability. For example, the CEO’s variable remuneration in 2016 was linked to progress against 12 commitments outlined in their corporate social responsibility policy, including contributions to achieving the UN Sustainable Development Goals. BNP Paribas has also developed nine indicators of sustainability performance which are used to determine the variable incentive plan for the 5,000 top managers, accounting for 20 percent of the eligibility conditions.³⁴

Heavily regulated sectors are the most likely to link environmental or social issues to compensation

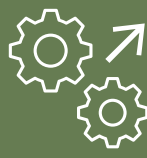
Highly regulated and production-intensive industries such as utilities (75 percent), materials (59 percent), and energy (52 percent) are the most likely to link executive compensation to sustainability. This may be driven in part by regulatory and legal risks of not complying, and the intense public scrutiny of environmental, health and safety measures for these industries. A more implicit understanding of how certain sustainability issues can impact shareholder value may also drive performance in these sectors.

Percentage of companies per sector that link executive compensation to sustainability performance



Leading practice: Executive compensation linked to sustainability

At **Xcel Energy**, executive compensation is linked to sustainability metrics. Public safety (15 percent weight of annual incentive) and employee safety (20 percent weight of annual incentive) were among the key performance indicators used in 2016 to determine the annual incentive for directors.³⁵ The long-term incentives for executives also included performance shares targeted to deliver a 26 percent average reduction in CO₂ emissions over a three-year period (30 percent weight of long-term incentives).



How do large global companies perform on sustainability?

Most large companies have sustainability commitments that are backed by company leadership and employee involvement

SUSTAINABILITY COMMITMENTS



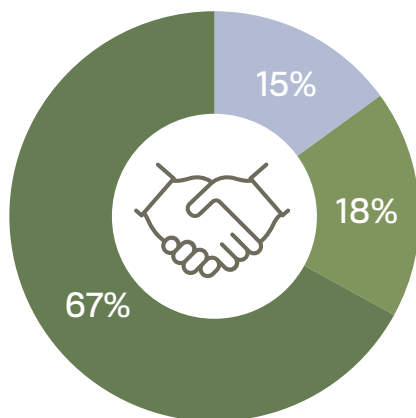
→ Commitments apply throughout the company

Most large companies (85 percent) disclose that they have adopted sustainability commitments that include support from the board or senior management. Some 67 percent of companies also disclose how employees are directly involved in achieving these commitments. To be credible, commitments should be backed by action. By demonstrating grasstop leadership support and grassroots involvement of employees, large companies are attempting to show how their commitments go beyond being simply symbolic.

When a company determines that specific environmental and social issues are material and includes them in strategy and goal-setting, the board is responsible for asking management the right questions to determine that progress is being made on those issues.

Holding senior decision-makers, including the C-suite and board of directors, accountable for sustainability performance leads to more ambitious commitments. *Turning Point*, a 2018 Ceres analysis of 600 of the largest U.S. companies, finds that 98 percent of the businesses with company-wide targets to cut greenhouse gas emissions within a specific time period hold senior executives accountable for sustainability.³⁸

Percentage of companies with a sustainability commitment that applies throughout the company



- No commitments, or no there is no disclosure of this information
- Company-wide commitments, supported by the board / senior executives
- Company-wide commitments, supported by the board / senior executives and with direct involvement of other employees



Leading practice: *Sustainability commitments integrated within corporate governance system*

Novo Nordisk has legally anchored its commitment to sustainability within the company's articles of association which states that the company "strives to conduct its activities in a financially, environmentally, and socially responsible way."³⁶ The company has developed ambitious long-term environmental and social targets that are aligned with corporate strategy and are overseen by the board.³⁷ Progress against targets is disclosed in the annual integrated report where quantified metrics of financial, social and environmental performance are presented together.



Companies with stronger sustainability commitments demonstrate better performance on sustainability

Our data show that companies that have sustainability commitments also demonstrate better performance on a range of sustainability issues, including environment, community involvement and human rights metrics. The strongest correlation is between sustainability commitments and environmental performance.

Why? When a company publicly commits to stronger sustainability goals—with the inclusion of board and management sign off—leadership will oversee that these commitments are being met. They may even receive questions from outside groups, including investors, about the progress made on time-bound commitments and goals. And because senior management drives stronger commitments overseen by the board, employees and teams across the business have an impetus to implement these goals within company operations and the supply chain.

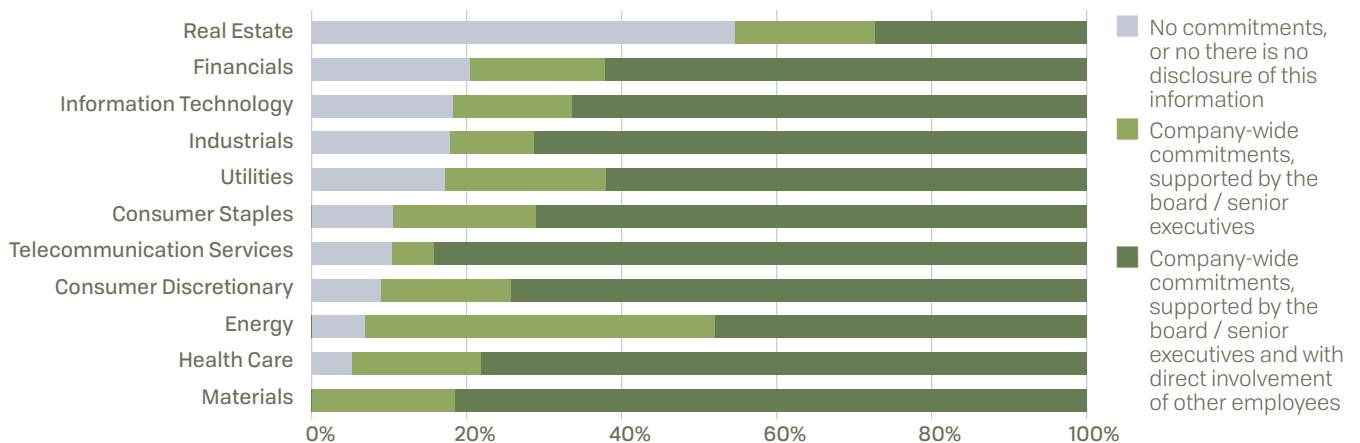
Larger companies perform better on sustainability, somewhat

Our analysis shows that larger companies have moderately higher sustainability performance scores. The average score for larger companies (those in the top quartile for company size as determined by their Forbes ranking) is 39.7, compared to an average score of 36.0 for the bottom quartile. The majority of scores in these quartiles fall between 24 and 53.

Most sectors provided robust disclosure of their sustainability commitments—especially those with greater exposure to risk

Companies in most of the sectors that we analyzed provide detailed disclosure about their sustainability commitments. Notably, all the companies in the materials sector have company-wide sustainability commitments. That may be due to the direct impact that social and environmental issues (use of hazardous chemicals, employees exposed to physical risk) have on this sector, compared to other sectors where a greater proportion of impacts are found in the supply chain.³⁹

Percentage of companies a sustainability commitment that applies throughout the company





Are board governance systems in large global companies effective?

IMPROVED SUSTAINABILITY PERFORMANCE



Today's boards must move beyond seeing governance *and* sustainability as two separate issues and adopt an integrated process of governance *for* sustainability. Yet, it can be difficult to know which actions will be effective. If a board improves governance for sustainability practices, what outcomes can be expected? Based on a statistical analysis of data from companies in the Forbes list, we examined how board governance systems and the links between them improve a company's sustainability commitments and sustainability performance.

Formal board mandates for sustainability are correlated with stronger sustainability commitments and better sustainability performance



Data Insights:

Formal Mandates → Commitments

A company with formal board mandates for sustainability is **2.1 times more likely** to have stronger sustainability commitments

Commitments → Formal Mandates

A company that has strong sustainability commitments is **3.6 times more likely** to have formal board mandates for sustainability

Formal Mandates → Sustainability Performance

A company with formal board mandates for sustainability is likely to demonstrate stronger performance for human resources, environment, business behaviour, community involvement and human rights metrics

Our analysis shows that companies with formal mandates for sustainability are more likely to have stronger sustainability commitments and better sustainability performance scores.

Why? When sustainability is formally placed on the board agenda, directors pay attention to key issues. They are more likely to be aware and informed about sustainability and therefore work with management to drive action. When sustainability is the focus of board discussions, management may also feel a more urgent need to establish clear metrics, targets and timeframes for measuring progress. Creating formal mandates for sustainability may also support better communication around sustainability issues between the board and management, facilitating an information flow that is critical to success.

The converse is also true. When a company has publicly committed to stronger sustainability goals, there may be a greater impetus to ensure that these commitments are being met through more formal oversight systems. Sustainability goals are more likely to be discussed and reviewed at board meetings, perhaps due to more comprehensive information and data coming from C-suite executives that report directly to the board and influence board decision-making.



Better board expertise on sustainability is directly correlated with stronger sustainability commitments



Data Insights:

Board Expertise → Sustainability Commitments

A company whose board includes directors with expertise in sustainability is **2.7 times more likely** to have stronger sustainability commitments

Our analysis shows that company boards with directors who are fluent in sustainability are more likely to have robust sustainability commitments. And this in turn, leads to better sustainability performance.

Why? Sustainability-competent directors are critical to companies. They combine their knowledge of sustainability with their responsibility as a member of the board to oversee business risks and opportunities and deliver positive business outcomes. When a company recruits more directors with expertise or previous exposure to sustainability issues, boards are better equipped to oversee these issues and to discuss key business risks and opportunities in a strategically relevant way. Discussions about the potential impact of relevant sustainability issues are more deeply informed, thus enabling board members to gain a better understanding on how to act.

As companies become more sophisticated in their understanding of what board expertise on sustainability *means* and start to relate it to material sustainability priorities, we expect the correlations to sustainability commitments and performance to become stronger.

Linking executive compensation to sustainability performance is directly correlated with stronger sustainability commitments



Data Insights:

Executive Compensation → Sustainability Commitments

A company that provides robust linkages between executive compensation and sustainability is **2.1 times more likely** to have stronger sustainability commitments

Our analysis shows that incentivizing executives on sustainability issues can be associated with stronger commitments to sustainability throughout the company. That, in turn, can lead to better sustainability performance.

Why? When a corporate board links executive compensation to sustainability priorities, it sends the message that becoming a sustainable corporation is a business imperative. A recent study by Deutsche Bank found that companies with ESG-linked executive compensation or board oversight financially outperformed other companies, both in the short and long term.⁴⁰



However, as noted earlier, the proportion of companies that provide robust and clear links between executive compensation and sustainability is quite small. Executive compensation systems are notoriously complex, frequently opaque and sometimes include compensation priorities that act against one another. As companies create compensation systems that clearly and transparently prioritize material sustainability issues, we expect to see the correlations to sustainability performance to become stronger.

Board governance systems reinforce each other



Data Insights:

Formal Mandates → Board Expertise

A company that has a more formal mandate for sustainability at the board level is **1.6 times more likely** to have more board members with demonstrated expertise on sustainability issues

Board Expertise → Formal Mandates

A company whose board includes directors with expertise in sustainability is:

- **2.5 times more likely** to have a more formal mandate for sustainability at the board level
- **2.3 times more likely** to more comprehensively review sustainability issues at board meetings

Formal Mandates → Executive Compensation

A company that has more formal responsibility for sustainability at the board level is **1.5 times more likely** to link executive compensation to sustainability performance

Executive Compensation → Board Expertise

A company that more formally links executive compensation to sustainability performance is **1.7 times more likely** to have more board members with demonstrated expertise in sustainability

Our analysis showed that the board governance systems we examined appear to reinforce each other.

Why? The positive relationships that exist between governance systems indicate that when boards make improvements in more than one area, they might enter virtuous cycles of improvement in their overall governance systems for sustainability.

For instance, formal board mandates for sustainability and improved board expertise are mutually reinforcing. Companies with board oversight tend to have directors with more sustainability expertise, and vice versa. Board oversight systems will be easier to implement if directors already have relevant sustainability skills and expertise. Formal mandates, in the meantime, may put pressure on boards to improve directors' skills on the issues they oversee, while the steps take to educate directors may trigger changes in the recruitment criteria for new directors.

The impact of compensation systems is also worth noting. Companies with more formal mandates for sustainability are more likely to link executive compensation to sustainability metrics. Conversely, linking the compensation of executives to sustainability metrics and targets is associated with a greater likelihood that a company will have more formal responsibility for sustainability at the board level.



Linking compensation to sustainability performance also appears to have a positive effect on board expertise. One explanation could be that when executives are rewarded for sustainability efforts, there is a greater incentive to support the recruitment of board directors with the right skills for sustainability.

The positive relationships between governance systems show that good sustainability governance is more than the sum of its parts. An improvement in one area might have positive ripple effects in many other areas. Overall, our data shows that governance systems are complex and have many inter-related and inter-dependent parts. Boards seeking to implement governance for sustainability should consider the reinforcing relationships that exist between governance systems. This will support the overall effectiveness of their efforts.

The best performing companies for sustainability have holistic board governance systems that integrate formal mandates, expertise and incentives for sustainability



Data Insights:

Sustainability Performance ↔ Formal Mandates + Board Expertise + Executive Compensation

- Companies with top scores on sustainability performance are **1.8 times more likely** to have a formal mandate for sustainability at the board level
- Companies with top scores on sustainability performance are **1.8 times more likely** to comprehensively review sustainability issues at the board level
- Companies with top scores on sustainability performance are **4 times more likely** to have a board member with demonstrated sustainability expertise
- Companies with top scores on sustainability performance are **1.5 times better** to link executive compensation to sustainability performance

Our analysis found that rather than taking a piecemeal approach to board governance, leading companies integrate the three board governance systems we examined. The companies with the highest sustainability performance scores (those in the top quartile of sustainability performance) do significantly better across all three systems: board expertise, formal mandates and executive compensation.

Why? Since the governance system is made up of different pieces that are inter-related and inter-dependent, improving certain practices will influence and reinforce results elsewhere. For instance, the decision to link executive compensation to sustainability performance does more than just incentivize executive managers to work to hit sustainability commitments. It spurs the board to increase its sustainability oversight—in turn helping improve sustainability performance.

Integrating sustainability throughout all governance systems is key to driving sustainability performance.



Recommendations

Based on our analysis, there are few key takeaways that companies, their corporate boards, investors, and other stakeholders interested in strong board governance systems for sustainability should consider:

Make board governance systems holistic and integrated

The companies that perform best on sustainability issues are those that adopt all three board governance systems examined in our report. As companies adopt systems for sustainability at the board level, rather than just implementing one system integration opportunity, they should consider how they could implement all three board governance systems in a holistic manner. Also, they should set the systems up to reinforce one another.

Better integrated governance systems will establish a strong tone at the top and accountability for sustainability performance. That tone and accountability then permeates throughout the organizational structure. Our analysis also shows that stronger board governance systems for sustainability can be linked to strong sustainability outcomes.

Exercise sustainability oversight with an eye towards performance improvements

It is important to be aware of the governance line that separates the board and management. The board's role is to oversee and incentivize management, while management's role is to develop strategies and plans that drive the company's performance on sustainability.

However, the board can play an important role in asking the right questions and encouraging management to identify the right material issues for corporate performance, including an assessment of whether this could include environmental and social priorities, prompt management to set goals for these priorities, and incentivize management to deliver on these goals.

As our analysis notes, companies with the right sustainability commitments also perform better on environmental and social issues.

A foundation for integrated board systems

The 2014 Ceres report *View from the Top* outlines the life cycle of systems that companies should put in place to integrate sustainability at the board level. Specific strategies recommended include:

- Formalize sustainability as a board priority
- Incorporate sustainability in relevant board charters
- Develop informed sustainability oversight
- Align sustainability priorities with management approach, business performance
- Incorporate sustainability in strategic planning
- Include sustainability in risk oversight
- Incentivize management for sustainability performance
- Disclose the role the board plays in prioritizing sustainability



Board governance systems should not exist in a vacuum, but should rather be oriented towards performance on material issues

Our analysis also notes that the strongest performing companies do not just have the right board governance systems in place, they also link those systems to specific sustainability issues that are material to their organization's corporate performance.

Sustainability is a broad term and the role of the board is to oversee only those specific issues that are material to corporate performance. Boards should work with management to determine which sustainability issues are material to corporate performance and link this analysis to their board governance systems. This is why explicit sustainability oversight established through charter incorporation should focus on material issues. New director recruitment should also consider expertise on material sustainability issues and lastly, executive compensation should be linked to material sustainability issues.

Provide more detailed disclosure about board governance systems

While our analysis looked at the connections between board governance systems and sustainability performance impacts, our assessments were limited by the fact that corporate disclosure of governance systems, especially board governance systems, is not in depth. This may be driven by the fact that board discussions are privileged and companies provide limited disclosure on board priorities and decision making. Institutional experience in implementing certain systems, such as recruiting directors with the right skills for sustainability, is also still somewhat limited.

We recommend that companies provide more detailed disclosure on board governance systems for sustainability, including details on the material issues that the board prioritizes and high-level details on how those priorities are addressed in board decision making. Having these details will help demonstrate to stakeholders that board systems exist in more than name only.

Conclusion

Investors and other stakeholders have long focused on governance systems, including at the board level, that support sustainability because they assumed that better systems could lead to better performance. Now, thanks to our analysis, the jury is in and the news is good—the theory holds.

We hope that this work will be useful to companies, investors and other stakeholders who are interested in corporate governance and how to structure it so that is most effective for sustainability.

Yet, it is important to keep in mind that this report is an initial piece of research on this important issue and that our analysis is limited for two reasons.

As noted earlier, as our analysis is based on a data snapshot of a single moment in time, the time lag between the creation of these systems and the impact on corporate performance has not been captured. To get a deeper understanding, it will be important to continue mapping corporate systems and performance over a range of years.



In addition, our analysis is based on corporate disclosure on board governance systems, which is limited. To have a truly sophisticated understanding of the connections between board governance systems and performance, we need more detailed disclosure on the components of the systems in question and how they function in practice.

Nevertheless, the takeaway of the data is clear. Companies that want to be set up for strong sustainability performance should adopt strong board systems. Setting the tone from up top pays off for companies.



Case studies of leading practices

Companies seeking to improve their sustainability performance should aim to integrate sustainability into the corporate governance system. Below, we provide examples of leading companies that have addressed board sustainability governance systems in a holistic manner. The information gathered is current as of April 2018.

L'OREAL	
CONSUMER STAPLES – Personal Products	
	<p>Formal Board Mandate</p> <p>L'Oreal's Strategy and Sustainable Development Committee is composed of five board members and is chaired the company's CEO and Chairman. The committee examines the societal and environmental consequences of corporate strategy developments and oversees the company's commitments to sustainable development.⁴¹ The Group's Director of Corporate Social Responsibility and Sustainability reports to the Board progress made on the implementation of the company's 2020 sustainability commitments.</p>
	<p>Board Expertise</p> <p>The company's CEO and Chairman, Jean-Paul Agon was awarded the 'Pace Leadership In Ethics Award in 2009'.⁴² The Chairman of the Audit Committee, Virginie Morgon is also Vice-President of the Paris Committee of Human Rights Watch⁴³ George Liarokapis is also an advisor for the European Economic and Social Committee.⁴⁴</p>
	<p>Executive Compensation</p> <p>L'Oreal discloses that Chairman and CEO Jean-Paul Agon's annual variable remuneration is based in part on progress made towards the organization's 2020 sustainability targets, which include a 60 percent decrease in carbon emissions, water consumption, and waste generation.⁴⁵</p>
	<p>Sustainability Commitments</p> <p>The company's Sharing Beauty With All strategy has a number of quantitative 2020 targets including those relating to improving the environmental and social profile of its products, reducing its environmental footprint and engaging suppliers on sustainability.</p>



Case studies of leading practices

DANONE

CONSUMER STAPLES – Food Products



Formal Board Mandate

Danone’s Board Social Responsibility Committee oversees the company’s “non-financial information and ratings”, social policy and investments related to social aspects implemented by Danone. Danone’s Sustainability Integration Steering Committee (including representatives of from the environmental, social, health and nutrition functions of the company) reports regularly to the Social Responsibility Committee.⁴⁶ According to the 2016 Annual Financial Report, some sustainability topics were discussed at the board level, including - the replacement of the Sustainable Development Report with an integrated report, a review of Danone’s Packaging policy, monitoring of the activities of Danone communities, a review of the strategic policies presented to the Danone Works Council and an annual review of pay equality for men and women.⁴⁷



Board Expertise

Danone’s Chairman of the Board & CEO Emmanuel Faber was responsible for Social Responsibility and Innovation during his time as the Deputy General Manager at the Danone group. Gaëlle Olivier is the former Head of Communication and Corporate Responsibility of the AXA group.⁴⁸

Jean-Michel Sévérino is a former member of UN working group on sustainable development and has extensive experience on environmental and development topics from his work for the French Development Agency AfD.⁴⁹



Executive Compensation

Annual variable compensation and long term compensation of top executives has a social/ societal component, which is linked to Danone’s commitments. Additionally, Danone has integrated societal performance into its variable compensation system for 1,500 senior executives.⁵⁰



Sustainability Commitments

Danone’s Nature strategy and Nature 2020 commitments are supported by a Nature Department that reports directly to a member of Danone’s Executive Committee, Pascal de Petrini, who is Executive Vice-President of Strategic Resources Cycles.⁵¹ Pascal de Petrini reports to the CEO and Vice-Chairman of the Board of Directors of Danone.

Since 2010, Danone has involved a panel of external experts and stakeholders to help organize its strategic thinking and define the Group’s long-term road map. This panel will continue its work as the plan is rolled out.⁵²



Case studies of leading practices

NESTLÉ

CONSUMER STAPLES – Food Products



Formal Board Mandate

Nestlé's Nomination and Sustainability Committee (which includes the board chairman) oversees the company's long-term sustainability strategy, monitors performance against selected external sustainability indexes, reviews annual sustainability reporting and assesses the material interests of significant stakeholders.⁵³ The Committee periodically discusses how material non-financial issues affect financial performance and how Nestlé's long-term strategy relates to its ability to create 'shared value.'⁵⁴

The Board is supported by internal management bodies including the Nestlé in Society board (chaired by the CEO), the Operations Sustainability Council and the R&D Council for Sustainability and Nutrition.⁵⁵



Board Expertise

The Chairman of the board, Paul Bulcke, is a Co-Chairman of the 2030 Water Resources Group, which has the mission of helping countries achieve water security, in line with the United Nations Sustainable Development Goals.^{56,57} Bulcke was given the Concordia Leadership Award for 2017 for leading the company's ongoing commitment to sustainability and supporting the UN Sustainable Development Goals.⁵⁸ Ann Veneman, who serves on the Nomination and Sustainability Committee, was formerly the Executive Director of United Nations Children's Fund (UNICEF).⁵⁹ The role included supporting child health and nutrition and access to water.⁶⁰ Pablo Isla, who has been nominated for election to the board in 2018, was named the Best Performing CEO in the World, for driving the strong financial and ESG performance of fashion retail company Inditex.⁶¹

Nestlé added seven new independent directors over the last three years.⁶²



Executive Compensation⁶³

The annual variable remuneration of executive directors includes measures related to sustainability and corporate social responsibility, in line with the 'Creating Shared Value' strategy. Targets include the proportion of products with Nutrition, Health and Wellness benefits, delivering on 'Creating Shared Value' commitments and strengthening Nestlé's sustainability objectives.



Sustainability Commitments

Nestlé's Articles of Association define the company's purpose and state that the company shall "aim for long-term, sustainable value creation" in pursuing its business purpose.⁶⁴

Nestlé has developed a 'Creating Shared Value' agenda to drive positive and sustainable impacts across its business, which has involved mapping material issues against the United Nations Sustainable Development Goals. As part of this agenda, 42 public commitments have been created under a number of themes, including nutrition, health and wellness, water, environmental sustainability, human rights and others.⁶⁵ All the commitments are directly aligned with the business, and the majority include objectives to be achieved by the year 2020.

The implementation of sustainability commitments is supported by access to external advisory groups, including the Nestlé Creating Shared Value Council and the Nestlé Nutrition Council.



Case studies of leading practices

IBERDROLA

UTILITIES – ELECTRIC UTILITIES



Formal Board Mandate⁶⁶

Iberdrola’s Board Corporate Social Responsibility Committee is responsible for the advising the board on the “Mission, Vision and Values” of Iberdrola. The Committee is charged with functions such as reviewing Social Responsibility Policies and annual reporting, evaluating stakeholder relations, overseeing the company’s inclusion in international sustainability indices, and advising the board on the latest corporate responsibility trends and measurement tools. The Committee has a periodic training plan that ensures the refreshment of knowledge relating to corporate social responsibility, significant regulatory risks and leading international corporate governance practices.



Board Expertise

José Ignacio Sánchez Galán, Chairman and CEO, chairs the electricity cluster of the World Economic Forum and is a member of the UN-sponsored Global Sustainable Electricity Partnership.⁶⁷ He has extensive experience working in the renewable energy sector and regularly writes articles on topics such as the low-carbon economy.⁶⁸ He was previously awarded the FIRST award for Responsible Capitalism.⁶⁹ Inés Macho Stadler, Lead Independent Director, spent five years as a member of the International Scientific Advisory Committee of the Basque Centre for Climate Change. Samantha Barber, chair of the Corporate Social Responsibility Committee, spent nine years at chief executive of Scottish Business in the Community, an organisation that promotes the responsible business agenda to create social, environmental and economic prosperity.⁷⁰

As disclosed in the annual report of the activities of the board, an ongoing training and information programme is conducted for directors and there is an orientation programme for new members. Directors have access to a software application that provides access to training materials and information relating to meetings.⁷¹ In 2017, sustainability materials were shared with the board through the application on the following topics—climate change, the UN Sustainable Development Goals, ethics and compliance, and occupational health and safety.⁷²



Executive Compensation⁷³

Annual and multi-year variable remuneration are tied to the performance of the executive directors and indexed to performance in industrial, financial, and corporate social responsibility parameters.

For the Chairman and CEO, the parameters linked to variable remuneration for the years 2018-2022 include achieving a continual increase in female presence in senior positions, the presence of the company on sustainability indices such as the FTSE4Good and Dow Jones Sustainability Index and exceeding the ratio of training hours per employee in comparison to a benchmark of competitors.

During the 2018 Investor Day, Iberdrola’s Chairman and CEO talked about how the company’s long-term incentive plan is linked to the Sustainable Development Goals on climate action and affordable and clean energy.⁷⁴



Sustainability Commitments

Iberdrola has a set of fifteen Social Responsibility Policies, which detail the company’s objectives in social and environmental themes. These include the General Corporate Responsibility Policy, Stakeholder Relations Policy, Sustainability Policy, Environmental Policy and the Policy against Climate Change, among others.

For example, the Policy against Climate Change articulates the group’s commitments to be implemented across the business, including reference to international climate goals under the UN Sustainable Development Goals and the Paris Climate Conference, in addition to disclosing a specific target to reduce the intensity of greenhouse gas emissions to below 150 grams per kWh by 2030 and to be carbon neutral by 2050.⁷⁵ In addition, Iberdrola regularly reports on detailed sustainability commitments, has developed quantifiable indicators of performance in economic, environmental and social dimensions, and discloses the results in an annual ‘sustainability scorecard’.^{76,77}



Case studies of leading practices

CRÉDIT AGRICOLE

FINANCIALS – Banks



Formal Board Mandate

The Strategy and CSR Committee oversees the company’s strategic thinking on growth, investment and corporate social responsibility.⁷⁸ The Committee conducts in-depth reviews of strategic planning for international business lines, and annually reviews the corporate social and environmental responsibility actions of the company. The board receives reports on the work and opinions of the Committee from the Committee Chairman.



Board Expertise

Dominique Lefebvre, the Chairman of the board, has been a member of the French Economic, Social and Environmental Council (ESEC).⁷⁹ Raphaël Appert is Director of the Grameen Crédit Agricole Foundation, which strives to combat poverty through sustainable development and fair finance, promoting financial inclusion in emerging countries.⁸⁰ Françoise Gri, Chairwoman of the Risk Committee, is a specialist in IT Technology and Corporate Social Responsibility. She has been a member of the Corporate Governance High Committee (a body set up to monitor the implementation of the French Corporate Governance Code), the Ethics Committee of the French Business Confederation, and the French Economic, Social and Environmental Council (ESEC).⁸¹



Executive Compensation

All senior executives are eligible to receive variable compensation linked to social, customer and managerial value creation metrics.⁸² The CEO and Deputy CEO are eligible for variable compensation set respectively at 100 percent and 80 percent of their basic salary, with non-financial criteria accounting for 50 percent of performance conditions.

Corporate Social Responsibility (CSR) assessments of entities across the Crédit Agricole Group are aligned with the UN Sustainable Development Goals and compiled in the ‘Group FReD Index’, the results of which have an impact on senior management compensation across the group. Some entities include the results when calculating managers’ variable remuneration—this affect approximately 10,000 employees.⁸³



Sustainability Commitments⁸⁴

Crédit Agricole has a long-standing commitment to accelerating to sustainable energy transition, which is applied across all business lines. In 2015, the company committed to COP21 with four concrete targets, and in 2017 refreshed its climate objectives with a strategic roadmap that includes targets to arrange €100bn new financing for climate action and to invest €5 billion in the energy transition through dedicated asset management companies by end-2020.



Case studies of leading practices

BNP PARIBAS

FINANCIALS – Banks



Formal Board Mandate⁸⁵

BNP Paribas's Board Corporate Governance, Ethics, Nominations and CSR Committee is responsible for overseeing the company's CSR actions, including evaluating performance, monitoring the company's contribution to sustainable development, and maintaining the general balance of the board.⁸⁶

At management level, the Group Executive Committee makes decisions on CSR issues and presents the strategy to the board at least once a year. A business function

in charge of sustainable development reports to Group General Management. In addition, BNP has a team of dedicated CSR experts at headquarters and a network of over one hundred CSR correspondents working across the business.



Board Expertise

Jean-Laurent Bonnafé, CEO and Director, regularly publishes articles about sustainable finance and the transition to sustainable energy.⁸⁷ At the 2017 One Planet Summit, he spoke on the topic "risks and opportunities related to climate change" and agreed a partnership between BNP Paribas and United Nations Environment in 2017 to drive sustainable finance in developing countries.⁸⁸ Jean Lemierre, Chairman of the board, was formerly the President of the European Bank for Reconstruction and Development (EBRD), an international financial institution promoting sustainable growth and green energy.⁸⁹ Lemierre opened the 2017 Sustainable Future Forum, highlighting the bank's commitment to tackling climate change and sustainability issues.⁹⁰ Jane Fields Wicker-Miurin, Chair of the Corporate Social Responsibility committee, is the co-founder and a partner of Leaders' Quest, an international social enterprise that works with leaders in business, government and civil society to create a more equitable and sustainable world.⁹¹



Executive Compensation⁹²

Remuneration paid to corporate officers is aligned with the bank's social interest and integrates assessment criteria relating to corporate social responsibility. Executive management receives an annual variable component that considers qualitative aspects such as the implementation of strategy (particularly the transformation plan) and corporate social responsibility. For example, the remuneration of the CEO in 2016 determined that he successfully achieved measures such as the fulfillment of 12 commitments of the Corporate Social Responsibility Policy, including contributions to achieving the UN Sustainable Development Goals.

Additionally, BNP Paribas has developed nine indicators of corporate social responsibility performance, which are used to determine the variable incentive plan for the 5,000 Top Managers, accounting for 20 percent of the eligibility conditions.⁹³



Sustainability Commitments

BNP Paribas has a corporate responsibility strategy structured around 4 pillars and twelve commitments.⁹⁴ The strategy is aligned with the UN Sustainable Development Goals and applied across all business lines, networks, subsidiaries and countries.

The company has disclosed detailed commitments to the environment, covering the energy transition and climate stability and protecting ecosystems and biodiversity.⁹⁵ These include quantifiable and time-bound targets such as to reduce GHG emissions per employee by 25 percent in 2020 compared to 2012 and to double renewable energy financings to €15 billion in 2020.



Methodology

Data sources and sample

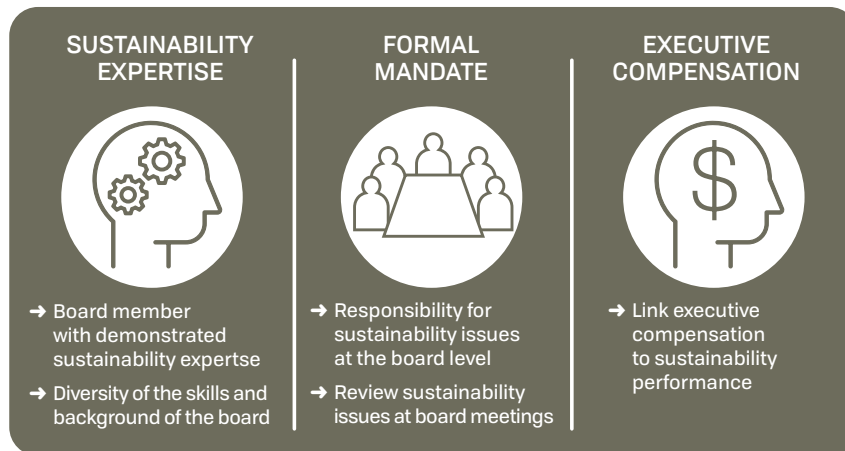
The research universe for this report comprises 475 companies from the Forbes Global 2000, an annual listing of the largest publicly listed companies in the world. The data was compiled by analysts at Vigeo Eiris, an independent provider of global environmental, social and governance (ESG) research and services for investors, public and private organizations and NGOs. For more information, visit www.vigeo-eiris.com.

The dataset on board governance systems covered three categories—board expertise, formal board mandates and executive compensation. Each category contained between one and two indicators (e.g. one indicator is 'board members with demonstrated sustainability expertise'), as depicted in the diagram below. For each indicator, companies received a score between 1 and 4, relating to their level of performance on that indicator—a score of 1 represented either poor performance or no company disclosure of the performance level, while a score of 4 represented the most advanced practices.

Relationships between governance systems

In order to explore potential relationships between data categories, we conducted a regression analysis on our dataset. An ordered logistic regression was carried out in Stata and the results presented as odds ratios, controlling for geographic location and sector. An odds ratio is a measure of association between an exposure and an outcome. The odds ratio represents the odds that an outcome will occur given a particular exposure, compared to the odds of the outcome occurring in the absence of that exposure.

We ran several iterations of the ordered logistic regression with a different dependent variable in each iteration. For instance, to estimate the impact of board expertise on formal board mandates, we used board oversight as the dependent variable and board expertise as the independent variable.



Sample Stata output

BoardReviewofSustIssues	Odds Ratio	Std. Err.	z	P> z	[95 % Conf. Interval]
BoardMemberswithExpertise	2.269352	.5821297	3.19	0.001	1.372629 3.751892



Links to sustainability commitments

To explore potential relationships between governance systems and sustainability commitments, we again conducted ordered logistic regressions in Stata, with results presented as odds ratios.

Sample Stata output

```

-----+-----
Sustainability Commitments | Odds Ratio  Std. Err.   z  P>|z|  [95% Conf. Interval]
-----+-----
Diversityoftheskillsandback | 1.976615  .4892878  2.75  0.006  1.216795  3.210902
IndicatorBoardmemberswithde | 2.685268  .9819147  2.70  0.007  1.311388  5.4985
  
```

Links to sustainability performance scores

To investigate the effect of sustainability governance practices on sustainability performance, we added company sustainability commitments and company sustainability scores to our data analysis. As many sustainability performance scores are composite (i.e. include an assessment of various sustainability metrics including environmental, social and governance), any analysis on the effect of sustainability governance practices would inherently have an existing correlation. To eliminate this effect, we removed all governance metrics from the dataset of sustainability performance scores. We therefore used other proxies of sustainability performance that could be included in our calculations—categorized under the themes of Environment, Community Involvement, Business Behavior, Human Rights, and Human Resources.

We ran five regressions to estimate the relationship between sustainability governance practices (board expertise, formal board mandates, sustainability commitments, and executive compensation) and sustainability performance (Environment, Community Involvement, Business Behavior, Human Rights, and Human Resources). Our model controlled for geographic location and sector. Values that have been omitted from the output table below were not statistically significant.

If a company improves its performance by one unit according to our methodology		Then the effect on the score for the various proxies of sustainability performance will be an INCREASE of:				
		Human Resources	Environment	Business Behavior	Community Involvement	Human Rights
Board Mandate	Responsibility for sustainability issues at the board level	—	1.5	—	1.9	1.7
	Review of sustainability issues at board meetings	2.9	2.0	2.4	3.6	2.1
Sustainability Commitments	Commitments apply throughout the company	2.8	6.1	2.4	2.0	2.8



Company size and sustainability performance

We tested the relationship between company size and sustainability performance by comparing the mean sustainability performance scores of the top quartile in terms of size (as determined by Forbes rank) against the bottom quartile. Stata outputs are shown below.

Two-sample t test with equal variances

```

-----+-----
Group | Obs   Mean   Std. Err.   Std. Dev.   [95% Conf. Interval]
-----+-----
1 | 119  39.69748  1.100074  12.00039  37.51903  41.87593
4 | 118  36.04237  .9982161  10.8434  34.06546  38.01929
-----+-----
combined | 237  37.87764  .7509494  11.56072  36.39822  39.35706
-----+-----

diff |      3.655106  1.486098      .7273285  6.582884

diff = mean(1) - mean(4)          t =  2.4595
Ho: diff = 0                      degrees of freedom =  235

Ha: diff < 0          Ha: diff != 0          Ha: diff > 0
Pr(T < t) = 0.9927   Pr(|T| > |t|) = 0.0146   Pr(T > t) = 0.0073

```

Importance of having all governance systems in place

To understand whether companies with the best sustainability performance are performing well across all governance systems, we compared the mean score per governance indicator from the top performing quartile against the bottom quartile. Results are shown below.

Indicator	Bottom Quartile (Sustainability Performance Laggards)	Top Quartile (Sustainability Performance Leaders)	Percentage Difference	Minimum Score	Maximum Score
Board members with demonstrated sustainability expertise	0.08	0.32	300%	0	1
Diversity of the skills and background of the board	2.08	2.94	41%	1	4
Responsibility for sustainability issues at the board level	1.49	2.7	81%	1	4
Review sustainability issues at board meetings	1.55	2.75	77%	1	4
Link executive compensation to sustainability performance	1.13	1.74	54%	1	4



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