STEERING THE SHIP: HOW GOVERNANCE SHAPES ESG OUTCOMES

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The environmental, social and governance (ESG) framework, which is crucial for promoting sustainability and ethics in corporate behaviour, often fails owing to a siloed approach separating environmental, social and governance-related aspects. Effective ESG requires a foundational focus on governance to enable environmental and social goals to be achieved. Building the right structure, culture and accountability (in one word, governance) is essential in order to realise true ESG ambitions and prevent greenwashing.

INTRODUCTION

The environmental, social and governance framework has emerged in recent years as a pivotal strategy for assessing and influencing corporate attitudes towards sustainability and ethical practices. This evolution stems from growing global demand for change.

Ideally, the ESG approach should be cross-cutting, with governance acting as an access code for the integration of environmental and social considerations into corporate dynamics. This "horizontal" approach is uncommon, though, with ESG rating providers and corporations often finding it easier to consider the three aspects vertically and separately. This approach increases the risk of creating silos and has proven to be suboptimal, however.

The first crucial step towards enhancing the efficacy of the ESG approach should be to recalibrate the focus to build the right governance. Governance should be the enabler that allows environmental and social ambitions to emerge through corporate dynamics. However, it often acts as a bottleneck in that regard. In this journey, building the right structure, culture and accountability is key to realising environmental and social ambitions and closing the door to greenwashing.

THE ORIGINS OF ESG

ESG considerations can be traced back to the socially responsible investment movements of the 1960s and 1970s, which stressed ethical and moral criteria in investment decisions, primarily in opposition to the Vietnam War and apartheid in South Africa. These movements laid the groundwork for considering non-financial factors in investment decisions. However, the concept of ESG as we know it today took on a more defined shape in the early 2000s, with a series of initiatives and reports that emphasised the integration of environmental, social and governance issues into financial analysis.

A landmark moment was the publication in 2004 of a report entitled *Who Cares Wins: Connecting Financial Markets to a Changing World*.[1] Commissioned by then United Nations Secretary-General Kofi Annan, the report was the outcome of a joint endeavour by the United Nations Environment Programme's Finance Initiative and the United Nations Global Compact.[2] It involved more than 20 financial institutions from across the globe. The *Who Cares Wins* initiative proposed that integrating ESG factors into investment analysis and decision-making processes could enhance traditional financial analysis by highlighting potential risks and opportunities that are not apparent through conventional financial analysis alone. This proposition marked a paradigm shift, suggesting that ESG factors were not just ethical considerations – tangential to business operations – but critical to financial performance and risk management.

1. See United Nations (2004).
2. The United Nations Global Compact is a voluntary initiative whereby chief executives commit to implementing universal sustainability principles and taking steps to support United Nations goals.

THE INTEGRATION OF ESG INTO MAINSTREAM INVESTMENT

Following the publication of the *Who Cares Wins* report, there was a notable move to integrate ESG considerations into mainstream investment practices. One of the most significant developments was the establishment of the Principles for Responsible Investment (PRI) in 2006.[3] Endorsed by the United Nations, the PRI provided a framework for incorporating ESG factors into investment decision-making, further cementing the importance of ESG in the financial sector. The PRI encourages investors to regard the three aspects of ESG as interconnected elements that can materially impact the financial performance of investments. The six principles promoted by the PRI do not look at environmental, social and governance-related factors as entirely separate aspects; rather, they encourage a cohesive approach which recognises that these factors can overlap and affect each other. The supporting framework and guidance[4] emphasise the interconnectedness of these aspects, rather than addressing them in silos.

Another pioneering endeavour is the Global Reporting Initiative (GRI)[5] – again, established in partnership with the United Nations Environment Programme – which issued the first set of sustainability reporting guidelines. These guidelines were developed to provide a framework for organisations to report on their ESG performance. Both frameworks underscore the importance of stakeholder engagement, which is a novelty in the rigid world of vertical "shareholders-board-management" hierarchies.[6] In practice, the GRI provides guidelines for disclosing how an organisation engages with its stakeholders, while the PRI focuses on the importance of incorporating stakeholder concerns into investment practices.

The business case for such initiatives was compelling. Organisations that adhere to GRI standards may find it easier to attract investment from PRI signatories, who seek out companies with strong ESG records as part of their investment criteria. Conversely, investors who are committed to the principles of the PRI may leverage GRI reports to monitor and assess the sustainability performance of their investment portfolios.

The PRI and the GRI have thus established an initial ESG "structure", whereby corporations can voluntarily adhere to agreed standards and report to the market, providing opportunities for investors who are keen to enhance their ESG exposure.

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3 See www.unpri.org. The PRI has more than 4,500 signatories globally, including asset owners, investment managers and service providers, who are committed to integrating ESG principles into their investment practices. The number of signatories is continuing to grow as awareness of and commitment to sustainable investing increases.

4 The PRI provides resources (including case studies, guidelines and tools) that help with the understanding and implementation of ESG integration. These principles often address complex scenarios where multiple factors interact, thus reinforcing an integrated perspective.

5 See www.globalreporting.org.

6 The first Organisation for Economic Co-operation and Development (OECD) Principles of Corporate Governance were issued in 1999. These acknowledged the role of stakeholders in corporate governance, emphasising the importance of recognising stakeholders' rights under the law and the benefits of active cooperation between corporations and stakeholders. The principles were revised in 2004, and the new version further highlighted the importance of going beyond legal compliance and fostering active cooperation with stakeholders to create wealth, jobs and sustainability. A 2015 revision provided additional guidance on how corporations can engage with stakeholders effectively. This led the way to the latest revision in 2023 and the addition of a new chapter on sustainability, where engagement with stakeholders is key.

Unfortunately, the limited oversight on how rigorously practices are applied has led to some "box ticking", whereby firms formally commit to those standards without meaningful implementation. This has raised concerns that some organisations may be using their signatory status to suggest a commitment to sustainability that is not matched by their investment practices.

Environmental groups and climate activists – jointly with academia – play a major role in fighting this approach and pushing for more accountability by raising awareness, engaging in direct advocacy, influencing policy and collaborating with corporations to improve sustainability. They often leverage media campaigns to influence public opinion and corporate reputations, potentially leading to divestment and the boycotting of companies with poor environmental practices. Activists have also taken legal action to enforce compliance with environmental regulations. By pushing for more detailed ESG disclosures and better practices, they play a crucial role in creating a culture and steering companies towards sustainable operations. Their efforts help to align corporate actions with global sustainability goals, contributing greatly to the broader fight against climate change and environmental degradation.

DIESELGATE

The scandal commonly referred to as "Dieselgate" was uncovered thanks to investigative work by researchers and subsequent regulatory action.

In 2014, a group of researchers from West Virginia University, funded by the International Council on Clean Transportation (ICCT), conducted tests to compare the emissions from European and American models of diesel cars. They intended to prove that diesel vehicles could meet emission standards effectively. The cars chosen for the tests included a Volkswagen Jetta, a Volkswagen Passat and a BMW X5. During on-road testing, the researchers discovered that the nitrogen oxide emissions of Volkswagen vehicles were up to 40 times the level allowed in the United States of America. The ICCT, surprised by the findings, reported the results to the Environmental Protection Agency and the California Air Resources Board, urging them to investigate further. In September 2015, after being confronted with evidence, Volkswagen admitted to installing software in diesel engines that could detect when they were being tested, changing the performance accordingly to improve results. This software had been installed in about 11 million cars worldwide from 2009 to 2015.

DISCLOSURE MATTERS

At the time of the Dieselgate scandal in 2015, Volkswagen was regarded as a leader in the field of sustainability, and its ESG disclosures were generally considered to be of high quality. The company regularly published detailed sustainability reports that followed GRI guidelines and indicated a commitment to transparency and environmental concerns. These reports covered a wide range of ESG topics, including emissions, energy efficiency and corporate governance.

This case underscored the importance of the quality and integrity of reporting, showing that misleading disclosures could have far-reaching negative consequences for a company and its stakeholders. The trust and credibility that had been established through Volkswagen's sustainability reporting were severely damaged.

Dieselgate led to huge reputational, legal and financial consequences for Volkswagen (estimated at around US$ 30 billion) and contributed to heightened public awareness and distrust around corporate environmental practices and greater awareness of the environmental impacts of corporate activities. The scandal acted as a catalyst for environmental activists, providing a clear, compelling example of corporate malfeasance that could be used to rally support for stricter environmental regulations and corporate accountability. It served as a stark reminder of the urgency and importance of addressing climate change, ensuring corporate responsibility and establishing robust regulatory frameworks.

Volkswagen's 2014 annual report says: "Compliance is a cornerstone of sustainable business – a view expressly shared by the Company's management." Indeed, the case served, for many corporations, as a reminder that the requirement to disclose certain practices in accordance with an agreed methodology pursuant to a disclosed commitment is a matter of compliance. Because compliance is a risk function, the reputational risk derived from inconsistent disclosure suddenly became high. To mitigate such risk, a number of corporations turned to "greenhushing", silencing their disclosure practices.

A NEW APPROACH

As the urgency and economic costs of climate change became more apparent, governments began to consider the serious risks that a changing climate posed to the environment, economies and individual businesses. This led to global policy shifts, including international accords such as the Paris Agreement[7] and the 2030 Agenda for Sustainable Development,[8] which underscored the need for concerted action to mitigate climate change and adapt to its impacts.

A milestone was reached in December 2015 – the same year as Dieselgate – when the Financial Stability Board,[9] in response to a request from G20 finance ministers and central bank governors for more transparent financial reporting of climate-related risks and opportunities, created the Task Force on Climate-related Financial Disclosures (TCFD). The primary objective of the TCFD is to help companies to understand what financial markets want from disclosure in order to measure and respond to climate change risks, and to encourage firms to align their disclosures with investors' needs.

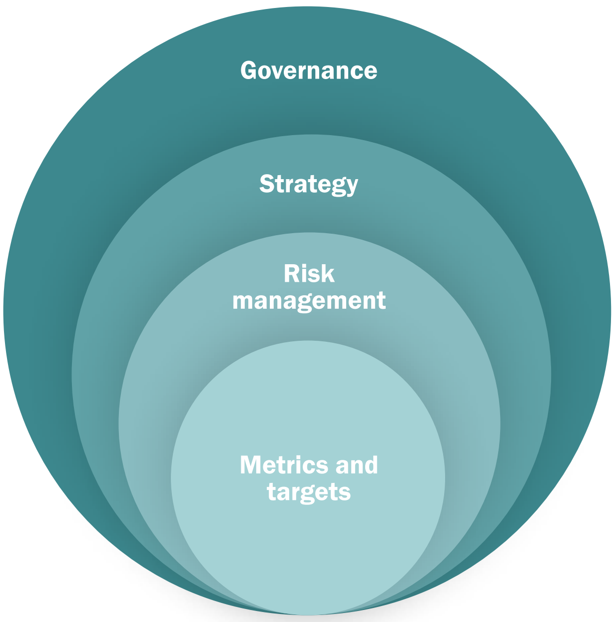
TCFD recommendations are structured around four thematic areas that represent core elements of how organisations operate (see Figure 1).

7 See https://unfccc.int/process-and-meetings/the-paris-agreement.

8 See https://sdgs.un.org/2030agenda.

9 See www.fsb.org. The Financial Stability Board is an international body that monitors and makes recommendations about the global financial system. It was established in April 2009 as a successor to the Financial Stability Forum after the G20 summit in London. Membership consists of all G20 economies, the European Commission and other key financial centres.

Figure 1. Core elements of recommended climate-related financial disclosures



- **Governance:** disclosure of the organisation's governance around climate-related risks and opportunities.
- **Strategy:** the actual and potential impacts of climate-related risks and opportunities on the organisation's business, strategy and financial planning.
- **Risk management:** the processes used by the organisation to identify, assess and manage climate-related risks.
- **Metrics and targets:** the metrics and targets used to assess and manage relevant climate-related risks and opportunities.

Source: TCFD (2017).

The central role of governance – as an enabler of all thematic areas – is clear from Figure 1. Each TCFD thematic area is, in itself, a governance aspect, where climate considerations are plugged in and shape the specific purpose of governance, thereby becoming the "enabler" for such climate considerations.

Generally, governance refers to the system of rules, practices and processes through which a firm is directed and controlled. It involves behaviours and encompasses the mechanisms through which executives – and, in turn, the company as a whole – are held accountable. This applies to performance, risk mitigation and environmental and social ambitions.

The TCFD approach is a horizontal approach, not a vertical one. It implies that effective interaction between shareholders, the board, management and stakeholders (first thematic area) is a precondition for developing an effective strategy (second thematic area), which, in turn, requires a solid structure for the assessment of risks and opportunities (third thematic area), which are to be disclosed using credible metrics (fourth thematic area). The linking of the four dimensions is key.

TCFD[10] reporting – while largely voluntary – is increasingly being monitored and incorporated into jurisdictions' regulatory frameworks. This shift makes companies more accountable for their climate-related financial disclosures and can potentially have legal implications if these disclosures – and the governance behind them – are found to be misleading or inadequate.

In some countries and regions, financial regulators, stock exchanges and industry groups are starting to encourage and require financial institutions and large companies to include TCFD-aligned information in their annual financial reports. Some stock exchanges, such as those in London, New York, Tokyo and Hong Kong, encourage or require listed companies to report in line with TCFD guidelines as part of their listing requirements.

On 6 March 2024, the US Securities and Exchange Commission (SEC) adopted final rules on the enhancement and standardisation of climate-related disclosures for investors, requiring corporations to disclose certain climate-related information in registration statements and annual reports.[11] Those rules are aligned with many of the TCFD's principles and recommendations. In particular, the SEC's rules highlight the importance of disclosing how the board and management oversee climate-related risks and opportunities. This includes descriptions of the governance framework and the processes for identifying, assessing and managing climate-related risks.

10 Following the release of its 2023 status report on 12 October 2023, the TCFD was disbanded, having fulfilled its remit. The Financial Stability Board has asked the IFRS Foundation to take over the monitoring of the progress of companies' climate-related disclosures. On 3 November 2021 at COP26 in Glasgow, the Trustees of the IFRS Foundation announced the formation of the International Sustainability Standards Board (ISSB), which has developed "IFRS S1: General Requirements for Disclosure of Sustainability-related Financial Information" and "IFRS S2: Climate-related Disclosures", incorporating the TCFD recommendations into the ISSB's standards.

11 See SEC (2024).

Figure 2. TCFD recommendations: the horizontal approach

Governance	Strategy	Risk management	Metrics and target
Disclose the organisation's governance around climate-related risks and opportunities.	Disclose the actual and potential impacts of climate-related risks and opportunities on the organisation's business, strategy and financial planning where such information is material.	Disclose how the organisation identifies, assesses and manages climate-related risks.	Disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities where such information is material.

Source: TCFD (2017).

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A WAVE OF NEW LEGISLATION AND LITIGATION

The United Kingdom was the first G20 country to enshrine mandatory TCFD disclosure in law. The legislation, adopted on 6 April 2022, requires more than 1,300 of the largest UK-registered firms and financial institutions to disclose climate-related financial information. This new requirement goes hand in hand with the United Kingdom's Companies Act 2006, Section 172 of which requires directors to act in a way that they consider, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole. This includes, among other factors, the need to consider the impact of the company's operations on the community and the environment. Increasing shareholder activism and public pressure have led companies to integrate more detailed environmental considerations into their strategic decisions, potentially under the ambit of Section 172 obligations.[12]

In the European Union (EU), the new Corporate Sustainability Reporting Directive (CSRD)[13] – an extension and revision of the earlier Non-Financial Reporting Directive (NFRD) – was adopted by the European Parliament in November 2022 and represents a significant step forward in the EU's commitment to sustainable finance and corporate responsibility.

The new directive covers all large companies – whether they are publicly listed or not – as well as all companies listed on regulated markets. This means that around 50,000 companies in the EU will now need to comply, up from around 11,000 under the NFRD.

12 This avenue started to be explored in 2023, when ClientEarth filed a derivative claim in the High Court of England and Wales against Shell's board of directors for alleged breaches of their duties under the Companies Act 2006. Despite the lack of solid legal grounds for ClientEarth's derivative claim, this case may serve to advance climate related goals under Section 172 of the Companies Act.

13 See European Commission (n.d.).

Companies are required to report on their impact on people and the environment. The directive will use mandatory EU sustainability reporting standards, which the European Financial Reporting Advisory Group is developing. Those reporting standards are expected to incorporate the principles and recommendations of the TCFD. Reporting will include detailed information on; (i) companies' business models, strategies and targets; (ii) the roles of the administration, management and supervisory bodies as regards sustainability; and (iii) the principal adverse impacts connected with the company and its value chain. For the first time, an external auditor or certifier must audit or check the sustainability information reported under the CSRD.

In jurisdictions where TCFD reporting has become mandatory, companies are legally accountable for the accuracy and adequacy of their disclosures. Failure to comply can result in fines, sanctions and other regulatory action. Furthermore, investors are increasingly demanding reliable and standardised climate-related disclosures to assess risks associated with their investments. Companies that fail to provide meaningful and accurate data may face shareholder activism and reputational risks, potentially leading to divestment and challenges in raising capital.

These reforms have started to create a system of accountability for disclosures. There have been instances where companies have been sued for allegedly misleading investors about their exposure to climate-related risks or the robustness of their climate strategies. In this process, courts are pivotal in upholding ESG standards and adjudicating on disputes related to environmental and social issues. Litigation regarding climate-related disclosures is expected to increase as more firms begin to report these details and regulatory requirements tighten.

> “The EBRD is helping its clients to systematically integrate climate considerations into their decision-making, risk management, investment and operational plans and targets through its Corporate Climate Governance Facility.”

Notable cases include the proceedings that were brought in the United States against the oil and gas giant ExxonMobil, which was accused of misleading investors about the risks climate change posed to its business. Though ExxonMobil prevailed in this case,[14] it highlighted the potential legal risks associated with climate-related disclosures. In another case filed in the Netherlands, ClientEarth initiated legal action against Shell's board of directors. The group of shareholder activists alleged that Shell's climate transition plan was inadequate and that the company's directors had failed to adequately prepare for a transition to a low-carbon economy. In May 2021, The Hague District Court ordered Shell to reduce its carbon dioxide emissions by 45 per cent by 2030 relative to 2019 levels. This reduction pertains to the entirety of Shell's operations and the energy products it sells, reflecting a substantial increase in the ambition of the company's existing sustainability policies.

Litigation is not limited to corporations, either. The landmark case of Urgenda Foundation versus The State of the Netherlands,[15] where the Dutch Supreme Court ordered the government to reduce its greenhouse gas emissions, exemplifies the role of the judiciary in enforcing environmental commitments. Courts can thus reinforce governance frameworks by ensuring legal accountability for ESG commitments and claims.

14 See People of the State of New York v. ExxonMobil Corp., filed on 24 October 2018 at the New York Supreme Court.

15 For more information, see https://climatecasechart.com/non-us-case/urgenda-foundation-v-kingdom-of-the-netherlands.

CONCLUSIONS

To sum up, the development of ESG has demonstrated the increasing role of governance in facilitating the transition to environmental and social sustainability. This "enabling" role is a cornerstone of the transition to sustainability. It requires horizontal integration of the ESG dimensions, with governance being the entry point and the glue that keeps the three together. Thus, in order to tackle climate risks, for instance, investors should be assured that the company has a sound risk management function in place where climate risks can be duly identified and analysed along with other operational risks. This does not go well with a vertical siloed approach, where environmental, social and governance-related elements are analysed and rated separately. Evidence shows that where ESG ambitions are siloed, they may not translate into tangible results.

Instead, an effective governance structure allows environmental and social goals to become corporate strategic priorities, while social and environmental challenges and risks are analysed holistically so they can, ideally, be turned into opportunities. This requires strong interaction between internal and external stakeholders, supported by a regulatory system that allows accountability and trust. The structure, culture and accountability that are required for this to happen are growing fast, but they still face some bottlenecks (for example, when it comes to the inclusion of stakeholders in decision-making, reliable disclosure and oversight) – especially in transition countries, where the ESG journey has only recently started and governance practices and frameworks may not yet follow best practices. The EBRD is helping its clients to systematically integrate climate considerations into their decision-making, risk management, investment and operational plans and targets through its CCG Facility.[16] The CCG methodology is based on the TCFD and is regularly updated to reflect emerging international standards and good practices.

Corporate performance has, historically, been measured using globally agreed, monitored and regulated financial indicators, whereby management informs the board, shareholders and stakeholders of profits and losses. A robust, standardised and evolving governance framework supports the preparation, verification and disclosure processes, ensuring confidence and trust. The same approach should eventually apply to environmental and social considerations as well.

16 In 2022, the EBRD officially launched its Corporate Climate Governance Facility, which aims to transform the way corporate clients do business by building their capacity to manage climate-related risks and opportunities and unlocking green investment. For more information on the CCG Facility, see www.ebrd.com/ccg-facility. For information on a pilot case study, see EBRD (2021).

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