Transforming Board ESG Oversight

With the growing emphasis of environmental, social, and governance (ESG) issues in recent decades, boards should assess how they are approaching ESG matters and consider what constitutes robust ESG oversight. Two seasoned business leaders—an ESG advisor to CEOs and boards of directors for the past 30 years and a senior executive of global companies—share their insights about ESG transformation.

By Gib Hedstrom and Paul Camuti

Over the past two decades, environmental, social, and governance (ESG) issues have been appearing more frequently on CEO and board agendas. In recent years, the pace has accelerated rapidly, driven by investor interest, competitive pressure, and human capital issues. Investors ask about ESG oversight, ESG ratings (put forth by Institutional Shareholder Services, MSCI, S&P Global, etc.), workforce diversity, ESG tied to compensation, and even corporate culture as companies assess their likelihood to achieve growth goals and remain resilient in the face of challenges. Competitors are setting net-zero goals for greenhouse gas, or GHG, emissions and launching products that are purportedly better for the environment. Employees routinely indicate they care about company purpose. And the role that businesses play in uplifting people and society is becoming increasingly adjoined with environmental and social justice expectations.

As a result of this increased ESG engagement by stakeholders, board members know ESG is important—but they would be wise to hit the pause button. They may be reacting to important indicators rather than deeply understanding the magnitude and scale of the business risks and opportunities posed by ESG issues. By focusing on data that is available only through company disclosures, they may fail to consider what constitutes robust board ESG oversight.

Directors should consider whether they are thinking about ESG the right way. To maximize long-term value for shareholders and create value for society, how should the board reflect the growing importance of ESG in its oversight?

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Through ESG Navigator's ongoing discussions with more than 100 major global companies, we have found that organizations fall into one of two buckets. Most are in what we call Group A, with a small but growing number in Group B.

Group A views climate change, global GHG emissions, biodiversity loss, social equity, and related ESG issues as serious problems. They have tracked climate disclosure requirements from the European Union and are focused on emerging US Securities and Exchange Commission (SEC) requirements. They read BlackRock CEO Laurence D. Fink's annual letters to shareholders and engage in dialogue with investors on ESG issues. They work on improving board ESG expertise and gradually enhancing board diversity, equity, and inclusion (DE&I). They ensure company reports align to Sustainability Accounting Standards Board or Task Force on Climate-related Financial Disclosures (TCFD) guidelines as BlackRock and other mainstream investors suggest. They monitor regulatory developments, engage with investors, track competitor actions, and understand workplace trends. These companies review their core businesses and approve strategies that reduce negative ESG impacts across the full value chain.

Group B views climate change as the defining issue of our day. The CEO and management team place ESG at the core of company purpose and strategy. They view sustainability as a disruptive platform for innovation that has the potential to stimulate a significant wave of growth. They see many other global challenges (e.g., food and freshwater insecurity, forced migrations, deforestation, supply chain disruptions, and health challenges) as tied to and exacerbated by climate change. Group B companies view the global decarbonization challenge as requiring every company to radically reduce GHG emissions, not only in their own operations but across the full value chain. They see that we are past the "tipping point" and the race is on to transform companies for success in a decarbonized world that is grounded in social equity. They invest in creating a set of products, services, and solutions that help customers radically reduce their GHG emissions.

The board's ultimate purpose is ensuring the long-term viability and success of the company. Since ESG is fundamentally about understanding these increasingly material issues and navigating long-term change, the board should carefully assess whether being in Group A will be sufficient.

Group A companies monitor and adjust as needed to be a fast follower. They often believe that, perhaps with a few minor adjustments, the current board oversight roles and committee structure can work. Group B companies want to lead with ESG strategies as a key differentiator. They see corporate transformation as the imperative, knowing this can only happen if the CEO and board take the lead. They adjust board oversight after a careful look in the mirror.

THE OPPORTUNITY

ESG issues present the greatest set of business opportunities in more than a century. Since the discovery of oil in 1859, heralding the modern petroleum industry, virtually every aspect of society has been based on hydrocarbons. Now, within the span of the next few years, humanity needs to make a 180-degree turn: find a way to continue enjoying the benefits of a modernizing society while rapidly decarbonizing the global economy.

Companies need to transform to win the war for talent, to engage customers by helping them rapidly decarbonize and align with the circular economy, and to earn the trust of today's and tomorrow's stakeholders, including shareholders. This type of transformation requires unbridled transparency. Few companies today recognize ESG issues this way. But a growing number of leading companies do, and they are transparently reporting on it in the same way they account for and disclose their business performance.

This is not new. Twenty years ago, Gib Hedstrom wrote in NACD *Director's Monthly* that "Boards need to prepare themselves for a new onslaught of business risks…." The article was based on Gib's twenty years at Arthur D. Little as vice president and managing director of the management and technology consulting firm's global ESG practice. The article was based on questions he had been asked as an outside advisor during many Fortune 500 board meetings. The article also suggested that boards "should be asking the right questions now." Three key questions posed then are even more important today:

- How does our governance system stack up with respect to ESG?
- What would a sustainability audit of our business portfolio reveal?
- What is our carbon risk exposure and our strategy?

Back in 2002, CEOs at a small but growing number of companies recognized the scale of global environmental and societal issues as both risks and opportunities. A few companies made false starts, but others embarked on major transformations and have only ramped up efforts ever since. At the time, Paul Camuti was leading Siemens' technology and innovation work on the energy transformation of the industrial sector. As a European-based company, Siemens was ahead of its US counterparts in terms of the evolving environmental conversation; however, sustainability was not yet built into its core strategy. Instead, transformation began more commercially in the business as long-term scenario planning identified that an environmental focus, especially for industrial companies, presented a clear growth track. For the past eleven years, Paul has helped lead Trane Technologies' transformation into a sustainability leader as executive vice president and chief technology and sustainability officer. As a company specializing in heating and cooling buildings and refrigerated transport, it recognized not only the responsibility to connect strategy to sustainability, but the company also began to view it as a strategic opportunity.

THE ESG GOVERNANCE TRAP

Board ESG conversations today tend to be dominated by a handful of topics that only tell half of the story. Those topics include: ESG disclosures and ratings; board structure (should we have an ESG committee or have the full board own ESG?); DE&I (do our board and executive team stack up on DE&I benchmarks?); ESG goals (are we on track for net-zero emissions by 2050 or earlier?); and regulatory developments.

Those questions are important, but they do not address robust board ESG and sustainability oversight. ESG Navigator has 60 key performance indicators (KPIs) related directly to governance and strategy. Only half of those are covered by the most widely used 15 external ESG reporting frameworks and ratings. Full and robust board oversight of ESG issues addresses the following questions (a sample of the 60 governance and strategy KPIs):

- Full board oversight of ESG: To what extent is the full board actively and frequently involved, during and between meetings, in discussing ESG issues, risks, and opportunities?
- Company purpose, vision, and mission: To what extent is ESG our North Star, guiding every strategic decision?
- Commitments by the board and C-suite: What would it take for the full board to publicly commit to ESG and the intent of the United Nations Sustainable Development Goals (SDGs), the international blueprint for strategies that improve social economics and tackle climate change?
- Board committees, roles, and charters: Does each board committee incorporate relevant ESG topics explicitly in its charter?
- Board agendas regarding ESG: Do agendas provide for deep engagement in ESG learning, analysis of full value chain ESG risks, and considerable pre-reading to stimulate ESG learning between board meetings?
- ESG and sustainability in key business decisions: Does the company demonstrate a track record of factoring material ESG and sustainability risks into key business decisions?

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- Time spent on ESG in board meetings: Is the board spending sufficient time on ESG at each meeting and in each committee, and is it woven into critical discussions of corporate strategy?
- Board independence and ESG expertise: Does the board have strong ESG and sustainability expertise, bolstered by input from respected ESG leaders who actively understand, assess, and mitigate major ESG risks?
- Board DE&I: Does the board reflect the diversity of the workforce and market, including diversity of gender, race, ethnicity, life experiences, and more?
- Annual reporting and financial disclosures: Does the board review and approve ESG information published in the company's annual reports and disclosures?

A board with multifaceted diversity that spends sufficient time on ESG with full board and board committee agendas that drive deep engagement with ESG feeds directly into the board's ability to have robust oversight of ESG. These factors were among the ones Trane Technologies examined as the company reviewed its board governance structure and processes in 2020. The company benchmarked leading companies across industry sectors and geographies and used ESG Navigator, a widely used industry benchmarking and strategic planning platform.

ESG Navigator is endorsed by The Conference Board and used by more than 100 major corporations globally. The platform has evolved over 25 years to reflect current research, best practices, and direct input from dozens of board meetings. "ESG Navigator helps us understand what good, better, and best look like—and what's expected of our company as we progress," said Scott Tew, Trane Technologies' vice president of sustainability.

ROBUST BOARD ESG OVERSIGHT: A MODEL FOR 2022 AND BEYOND

Trane Technologies began to integrate ESG performance into its business in 2010 when it established its Center for Energy Efficiency and Sustainability and launched an internal Diversity and Inclusion Council. Shortly thereafter, the company issued its first climate materiality assessment and sustainability addendum to the annual report. It was during that stage of transformation that Trane Technologies' approach shifted, moving from an assessment of risk and compliance to be managed to building a platform of growth opportunities tied to United Nations Sustainable Development Goals and global megatrends changing the business landscape.

Those management team decisions to invest in strategy development and oversight of environmental and social matters material to the business put Trane Technologies on the path to its first set of major sustainability commitments in 2014. Around that time, the leadership team decided to underscore accountability for the company's increasingly strategic commitments by putting its emission reduction goals through the rigorous validation process of the

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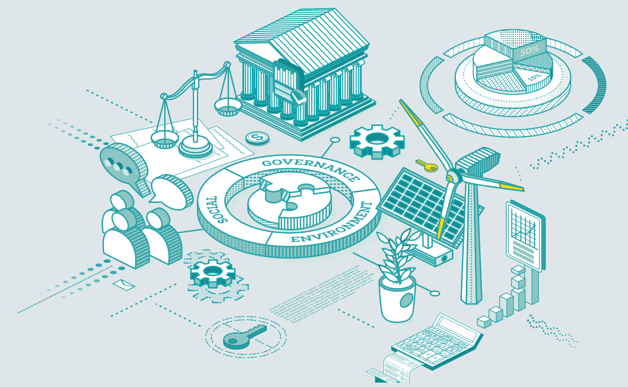


KEY TRANE TECHNOLOGIES MILESTONES

- **2010:** Launched the Center for Energy Efficiency and Sustainability
- **2011:** First submission to Dow Jones Sustainability Indices
- **2012–2013:** Formed internal and external Sustainability Advisory Councils and conducted the first climate-based materiality assessment
- **2014:** First set of major 2020 Climate Commitments
- **2015**: Launched the EcoWise product portfolio and the 2020 Climate Commitments were validated by the SBTi
- **2017:** Joined Paradigm for Parity and CEO Action for Diversity and Inclusion
- **2018:** Achieved 2020 Climate Commitments two years early
- **2019:** Announced 2030 Sustainability Commitments, including the Gigaton Challenge, and joined RE100, EP100, and 3% Club
- **2020:** SBTi validated the 2030 emission reduction commitments; both ESG and financial highlights included in the annual proxy reports; and an ESG commitment letter from the board of directors was published in the proxy
- **2021:** Refreshed the board committee structure for oversight of workforce and sustainability efforts and added an ESG modifier for the annual incentive program for 2300 senior leaders
- **2022:** SBTi validated the Net-Zero by 2050 target

Science Based Targets initiative (SBTi) and adding performance factors for its 2020 Climate Commitment targets in the goals of senior business leaders.

In 2019, as it prepared to separate from its industrial business (Ingersoll Rand) and become Trane Technologies, a pure-play climate company, it set even bolder ESG goals and raised expectations about what the company could do. Those expectations included a new set of 2030 Sustainability Commitments, including a first-of-its-kind, business-to-business commitment to reduce customers' carbon emissions by 1 billion metric tons—the Gigaton Challenge—which was also validated by the SBTi. In 2022, the company's Net-Zero by 2050 targets were among the first in the world to receive SBTi confirmation, another demonstration of ESG leadership.

It's not possible to set goals of this scale without transforming every aspect of your business strategy, and consequently the board's role in strategy design and oversight for performance. While it did not get to this stage of maturity overnight, Trane Technologies has made intentional steps to drive responsibility for ESG performance across every level of the company. (See sidebar on p. 35 for Trane Technologies' ESG journey.)

Before 2020, Trane Technologies leaders provided

FIGURE 1: TRANE TECHNOLOGIES BOARD ESG AND SUSTAINABILITY RESPONSIBILITIES

FULL BOARD OF DIRECTORS

- Oversee annual reporting and disclosures
- Monitor brand and reputation
- Ensure learning and development
- Oversee company culture and employee engagement

SUSTAINABILITY, CORPORATE GOVERNANCE, AND NOMINATING COMMITTEE

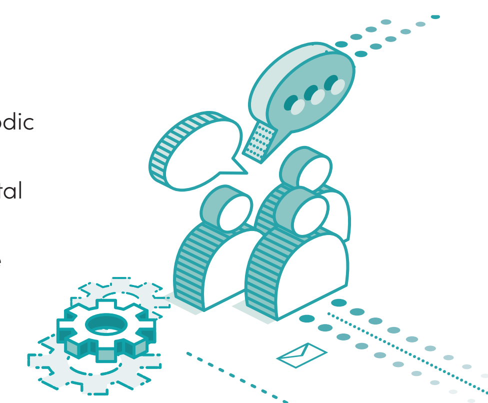
- Oversee the company's purpose and ESG and sustainability efforts
- Shape the company's sustainability efforts and corporate governance
- Oversee development and implementation of policies related to ESG issues
- Monitor performance against sustainability and ESG objectives including those related to climate change
- Evaluate social and environmental trends and issues related to the company's businesses
- Make ESG policy recommendations to the board
- Assist the board in evaluating the performance of the board committees, including reviewing results of each committee's annual self-evaluation

AUDIT COMMITTEE

- Review disclosure practices included in the company's periodic external reports
- Review and assess human capital management and other ESG disclosures to be included in the company's annual report on Form 10-K
- Oversee ethics
- Review enterprise risk management process and results

HUMAN RESOURCES AND COMPENSATION COMMITTEE

- Review human capital management initiatives related to leadership talent recruitment
- Review issues related to diversity and inclusion, pay equity, and hourly wages
- Set, review, and approve ESG factors for the company's annual incentive matrix
- Review and assess, with the sustainability, corporate governance and nominating committee, and the audit committee, human capital management disclosures for the annual report on Form 10-K



TECHNOLOGY AND INNOVATION COMMITTEE

- Assist the board in overseeing certain environmental matters including climate change, greenhouse gas emissions, energy-efficient and low-emissions products, and product life cycles and materials
- Review technology trends that could significantly affect the company and the industry in which it operates
- Monitor supply chain transparency and performance
- Monitor product reliability and safety

FINANCE COMMITTEE

- Evaluate sustainability financing opportunities
- Oversee credit facilities, including sustainability-linked provisions

comprehensive and robust reporting to the board of directors, which was often connected to the board's oversight of public disclosures, like the Carbon Disclosure Project (CDP) and TCFD. The board did not and does not have a separate ESG committee. In 2020, the board conducted a comprehensive review and ultimately transformed board ESG oversight. It retained the core structure of both full board oversight and individual committee responsibilities. However, it made other important structural changes.

Board structure until 2020. Previously, sustainability oversight fell under the purview of the board nominating and governance committee, and in 2016 fell under shared responsibilities with the technology and innovation committee. The management team presented annual ESG updates to the full board, with additional sustainability details included for the technology and innovation committee as they related to growth opportunities in solution development strategies.

Board structure 2021 to present. Since 2021, every board committee has been given specific ESG oversight responsibilities. The board reviewed committee charters to align risk and ESG oversight and amended them to reflect these responsibilities. This included changing the corporate governance and nominating committee name to the sustainability, corporate governance, and nominating committee to reflect the committee's oversight of the company's sustainability efforts, including the development and implementation of policies related to ESG. The board also amended the compensation committee name to the human resources and compensation committee to reflect the committee's broader purpose of key human resource management initiatives related to leadership talent recruitment and retention, diversity and inclusion, pay equity and wages, and setting, reviewing, and approving ESG factors for the company's annual incentive Matrix. (See Figure 1: Trane Technologies Board ESG and Sustainability Responsibilities)

As Trane Technologies increased ESG oversight of the board, the board concurrently instructed the leadership team to ensure internal management structure also directly reflected the strategic ESG ownership in the organization, including formalization of the role and responsibility of chief sustainability officer. Today, there is no separate view of ESG and the company's strategy: sustainability is the strategy, and it sets the company apart. From 2014, when Trane Technologies set its first generation of commitments through 2021 (the most recently ended fiscal year), the company's financial performance significantly outperformed the S&P 500 in total shareholder return growth. This demonstrates that a business can have financial success associated with ESG leadership. In fact, the risk of inaction has become even more acute as climate science warns of the need for urgent action and investors grow more interested in how companies can not only survive ESG risks but thrive and grow for the long term.

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ACTIONS BOARDS SHOULD TAKE

It's hard to transform your company if you don't also transform board oversight. There are three actions we recommend every board take today regarding ESG:

1. **Learn:** ESG is complicated. It encompasses global warming, world hunger, mass migration, social equity, community engagement, and more. It is easy to get lost in the weeds. For each company, only a handful of truly material issues pose increasingly stark risks and opportunities.

2. **Benchmark:** Evaluate external ESG ratings through the lens that they represent. They are important but are based only on information companies disclose publicly. At best, these ratings address half of the ESG topics that drive value creation. Conduct a robust examination of the full set of ESG issues by benchmarking peers, aligning your executive team internally, and zeroing in on the critical few strategic priorities. Figure 2 (p. 38) provides a list of 10 of the 100 Key Sustainability Indicators listed by ESG Navigator that relate to board oversight. (A full list, along with detailed descriptors of all four stages of maturity, is available from ESG Navigator.)

3. **Engage:** Meet with leaders at companies engaged in transformation. Talk with customers in Europe. Do a deep dive into ESG, as a major North American utility company did in 2015 when the full board and full executive team engaged in a half-day scenario planning session to explore the potential impacts of ESG. (At the end of that session, the board chair said it was the best half day the board had ever spent and asked that the board add a half day to an upcoming meeting to continue the discussion.)

FIGURE 2: BOARD OVERSIGHT: 10 KEY SUSTAINABILITY INDICATORS (BASED ON THE ESG NAVIGATOR MATURITY MODEL)[1]

KEY SUSTAINABILITY INDICATOR	STAGE 1	STAGE 2	STAGE 3	STAGE 4
Company Purpose (Vision, Mission)	ESG is viewed as a corporate social responsibility or an extension of environment, health, and safety (EHS) and philanthropy. Company purpose, vision, and mission can enable ESG but the extent of ESG ambition may mean different things.			ESG is the North Star at the core of the company's distinctive role in society. Every strategic and key operational decision is guided by purpose, with ESG driving the goal of net positive impact.
Commitments (by Board and C-suite)	Company conforms to common industry practices and standards.			Company's full board of directors publicly commits to ESG (the intent of the SDGs).
Full Board Oversight of ESG	Full board oversight of ESG is not explicit or extensive. Responsibility for ESG is folded under a standing board committee (e.g., audit, nominating and governance).			The full board is actively and frequently involved (during and between meetings) in discussing ESG issues, risks, and opportunities. It invests time in special (e.g., half-day) sessions on ESG.
Board Committees, Charters, and Roles	Board roles and committee charters focus on conventional EHS and public policy issues, with only summary reference to ESG.			Every board committee incorporates relevant ESG topics, explicit in charters (updated frequently). The full board also addresses ESG issues comprehensively at least annually.
Board Agendas Regarding ESG	Board meetings typically cover EHS, philanthropy, ESG benchmarking, trends, and emerging issues. The chief sustainability officer reports goals and metrics related to operations. Board pre-reading is often limited, with few ESG thought leadership articles.			Board meetings involve ESG learning (e.g., scenario planning on ESG risks). The board discusses full value chain ESG risks and opportunities. Board members engage in systematic ongoing learning between board meetings.
ESG in Key Business Decisions	ESG elements are typically not factors in key business decisions (defined as those made by the C-suite and board).			Material ESG issues guide strategic planning and capital allocation. The company demonstrates a track record of factoring material ESG risks into key business decisions (made by the C-suite and board).
Time Spent on ESG in Board Meetings	Time spent on ESG (by the full board or a committee) is two to four hours per year. ESG is a key agenda item for at least one meeting per year.			Time spent on ESG at every meeting is very significant (greater than 12 hours per year in full board or board committee meetings).
Board Independence and ESG Expertise	The company discloses tenure of board members. Board ESG expertise is little to moderate. The board relies mostly on internal ESG experts and external industry associations.			More than 90 percent of directors are independent. The board receives input from respected ESG leaders. The board has strong ESG expertise. Directors actively understand, assess, and mitigate major ESG risks and opportunities.
Board Diversity, Equity, and Inclusion	Board diversity representation (gender, ethnicity, religion, etc.) is cumulatively less than 20 percent. May or may not have a board diversity policy.			The board reflects the diversity of the workforce and market, made up of 40 percent women and members of underrepresented groups. Directors have diverse life experiences.
Annual Reporting and Financial Disclosures	The CEO letter mentions material ESG issues briefly (if at all). Financial disclosures are mostly conventional. The company may issue a sustainability report and discuss ESG as a corporate social responsibility.			The company publishes and integrates ESG information in the annual report, which the board reviews and approves. ESG issues are not easily distinguished from core business issues. Strategic messaging is aligned with net positive impact.

[1] The ESG Navigator platform includes a four-stage maturity model with 100 key performance indicators (called Key Sustainability Indicators). Sixty of the 100 are in the governance and strategy sections; 40 are in the environment and social sections. The full list of 100 Key Sustainability Indicators, and the descriptors for all four stages, is available in the ESG Navigator Handbook: *https://esgnavigator.com/user/toolbox/handbook/*.

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SETTING THE EXAMPLE

The scale of what companies face today is on par with that of the Industrial Revolution. Despite the massive progress that has been made since the late 1800s, we still mostly burn petroleum to drive our vehicles and burn fossil fuels to light our homes and power our phones. Even the progress made by industrialization has not benefited everyone equally.

ESG demands a top-to-bottom rethink and redesign of every aspect of corporate governance and strategy. That is the role of the board. In his Jan. 18 letter to board members, State Street CEO Cyrus Taraporevala stressed that "companies [are] rising to the challenges of the moment by transitioning their strategies and operations as part of efforts to address the systemic risks of climate change and embrace new ways of recruiting and retaining talent." He noted that the path ahead may be relatively straightforward for some companies, but in general the transition will be very hard and nonlinear.

Other companies have been showing the way. Ford Motor Co., General Motors Co., and other major auto companies are changing more in the current five-year period than in the past 100 years combined by transforming away from the internal combustion engine to software-based, battery electric vehicles. Neste Oyj, the Finnish oil and gas company, transformed from refining oil to producing more sustainable energy sources. With a legacy of innovation and a passion for renewal, Neste Oyj reached its target to become the world's largest producer of renewable diesel. Ørsted was in 2008 one of the most coal-intensive energy companies in Europe. In just 10 years, it transformed from dependent on fossil fuels to renewable energy. Over that decade, Ørsted reversed the ratio (85 percent to 15 percent) of fossil fuels to renewables in its heat and power production. Unilever began a transformation during the 2008 financial crisis: In 2010, former Unilever CEO Paul Polman launched the bold plan to double growth while cutting in half the company's environmental footprint. After Polman's retirement, CEO Alan Jope has continued and accelerated the transformation.

Trane Technologies has learned from others and is building on its experiences to carve out a more sustainable and accountable path forward for its own industry and sectors beyond. ESG was already at the center of strategy when the company launched as Trane Technologies in 2020. Today, ESG leadership remains the strategic North Star and sits firmly at the heart of the company's purpose to boldly challenge what's possible for a sustainable world.

If ESG issues are not one of the top discussion topics for your board today, they should be. Not just once or twice a year. Not just under the purview of one board committee. Not just as a bullet point in a board committee charter. Not limited to the board packet and pre-reads. Not just in reaction to external ESG ratings or internal company reports on progress and goals. Climate change is the defining issue of our day. It's time to rethink and restructure board oversight with ESG squarely a priority of the full board and deeply woven into every board committee and function.

Gib Hedstrom is founder and managing partner of ESG Navigator, a corporate ESG benchmarking and strategic planning platform endorsed by The Conference Board. He is a member of the NACD Faculty and author of *Sustainability: A Guide for Boards and C-Suites and Sustainability: What It Is and How to Measure It.*

Paul Camuti is the executive vice president and chief technology, strategy, and sustainability officer of Trane Technologies, a global climate innovator delivering heating and cooling solutions for the world. Paul is a member of NACD serving on the boards of Discovery Place, Lehigh University, and most recently ExOne.