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U.S. Corporate Boards Suffer From Inadequate Expertise in Financially Material ESG Matters

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Her previous work included serving as Executive Director of the New York League of Conservation Voters, Vice President of the National Audubon Society, and Managing Editor of Ambio, a journal of The Swedish Academy of Sciences. Tensie has served on numerous corporate advisory boards for companies such as Unilever and Nespresso and currently serves on the advisory boards of ESG investing firms, Arabesque and Inherent Group. She is an Advisor to the Future Economy Project for Harvard Business Review. Tensie was awarded the Stern Faculty Excellence Award in 2020.

About NYU Stern Center for Sustainable Business

The NYU Stern Center for Sustainable Business' (CSB) mission is to prepare individuals and organizations with the knowledge, skills, and tools needed to embed social and environmental sustainability into core business strategy. In doing so, businesses reduce risk; create competitive advantage; develop innovative services, products, and processes; while improving financial performance and creating value for society. CSB implements its mission through activities in Education, Research, and Engagement. To learn more, visit our website at stern.nyu.edu/sustainability.

Introduction

Climate change, water scarcity, pollution, #metoo, #blacklivesmatter, worker welfare, employee diversity, bribery, human rights abuses, supply chain scandals... Not to mention COVID-19... These are just a few of the environmental, social, and governance issues (ESG) that are creating material risks and opportunities for corporations and investors, yet many boards have little related oversight or expertise.

Many directors do not even recognize the need; PWC's Annual Corporate Directors Survey found that only 38% of board members think ESG issues have a financial impact on the company (PWC 2020). Some 56% of directors complain that investors are giving too much focus to ESG--nearly twice those with that viewpoint in 2018 (PWC 2019). Just 34% said there needed to be more racial/ethnic diversity on their boards (PWC 2020).

However, in 2020, as societies have been slammed with the health and economic impacts of COVID and the mass protests associated with racism, corporate boards are rethinking this cavalier approach. Six in 10 directors now believe that environmental/sustainability expertise is important for a board (PWC 2020). According to Ernst and Young's Center for Board Matters 2020 report, the focus on human capital issues through reporting and board oversight has more than doubled from 2017, with companies more likely to report on gender and racial diversity, pay gaps, and so on, as well as to include oversight of those issues in a board committee. Boards are also concerned about environmental issues in 2020—with more reporting disclosure and oversight of topics such as climate change, energy efficiency and water. And companies such as Bloomberg are now tracking board governance issues such as diversity, tenure, roles and independence.

Yet, boards of directors may not be up for the task. Ex-corporate lawyer, Jamie Gamble, says current board culture is sociopathic and is calling for a set of ethical rules to guide decision-making (NYT 2019). And most board members do not have any background in the issues. Using big data algorithms, CERES reviewed the board credentials of the top 475 of the Fortune 2000 companies and found that most board members do not have demonstrable sustainability credentials (only 17% qualified) and just 13% of boards have robust oversight of ESG issues. Only 10% regularly reviewed relevant sustainability issues at board meetings (CERES 2018).

The 2020 EY study found most oversight of human resources issues was in the compensation committee and most oversight of environmental issues was in the governance and nominating committee. Those committees already have a full docket and the members may not have the requisite expertise. Board members should take notice because good performance on material ESG issues results in good corporate financial performance. One study (Khan et al 2016) of 2300 companies found that a portfolio invested in companies that perform well on material ESG issues would have a 6% out-performance on stock price. A portfolio characterized by companies with low performance on both material and immaterial ESG issues would under-perform the market by -2.9%.

Another study found that in an environment where firms are spending growing sums on litigation, strong ESG performance is correlated with lower penalties for regulatory violations and more importantly, reduces the likelihood of lawsuits by up to 13%. The results are consistent across E, S, and G – each yields 5-7% reduction in lawsuits for firms with individual CSR ratings one unit above the mean (Barnett et al 2017). With ESG becoming an issue of material risk, financial performance, and business strategy—the purview of corporate boards—we were interested to better understand the board composition of U.S. publicly owned companies.

Analysis of Fortune 100 Board ESG Credentials

To further explore the topic, NYU Stern's Center for Sustainable Business undertook a deeper dive and analyzed the individual credentials of the 1188 Fortune 100 board directors based on Bloomberg and company bios in 2019 (see box 1 on methodology), and found that 29% of (1188) directors had relevant ESG credentials. 29% seems like a decent showing, until we drill deeper and find that most of the experience is under the S; 21% of board members have relevant S experience, against 6% each for E and G (numbers are higher than 29% as some members had more than one credential). The "S" credentials were clustered around health and diversity issues.

And, going deeper by industry and by company, we find that many companies with material ESG issues have very little relevant expertise on their boards. We categorized board credentials under ESG as follows (Box 2):

S Categories	% With Relevant Credentials	E Categories	% With Relevant Credentials	G Categories	% With Relevant credentials
Workplace Diversity	5.0% (60)	Energy	1.2% (14)	Accounting oversight/experts	2.6% (31)
Health Care (physicians, hospital, clinic boards, etc)	3.5% (41)	Conservation/ Nature	1.2% (14)	Regulatory body (SEC, FCC)	1.0% (12)
Health challenges/advocacy	1.9% (22)	Sustainable Business	.08% (10)	Cyber/telecom security	.06% (8)
CSR/ESG	1.5% (18)	Sustainable Development	.08% (10)	Risk	.04% (5)
Civil/human rights	1.5% (18)	Environmental law	.05% (6)	Ethics/corruption/ corporate responsibility	.03% (4)
Youth education, health, safety	1.2% (14)	Environmental protection	.05% (6)	Fiduciary/director responsibility	.03% (4)
Economic/community development	1.1% (13)	ESG investing	.03% (4)	Governance	.01% (2)
Human Resources	.08% (10)	Climate	.02% (3)		
Adult education	.07% (9)	Water	.01% (2)		
Nonprofit CEO	.07% (9)				
Philanthropy	.07% (9)				
Sustainable development	.05% (6)				
Media/arts	.03% (4)				
Public policy	.03% (4)				
Affordable housing	.02% (3)				
Workplace benefits	.01% (2)				
Nutrition	.01% (2)				
Workplace safety	.008% (1)				
ESG Investing	.008% (1)				

Relevant Director Experience with "S"

"S" areas with material impact for companies—human rights, human resource development, benefits and safety, for example-- had negligible board member representation. On the other hand, across all ESG topics, the topical and urgent issue of workplace diversity had the largest number of directors with relevant credentials (5.0%). Mainly these directors were involved with boards or initiatives that focused on increasing minority leadership, such as Catalyst (supporting female leadership) and corporate diversity councils. Most were focused on women's representation, with others focused on Black and Latino representation. The second largest "S" category (3.5%) was board members with healthcare experience; generally through board memberships with medical facilities such as the Mayo Clinic, or they were physicians, medical researchers and academics. Most of this group, though not all, were serving on health care company boards. The health theme continued with health challenges/advocacy at 1.9%, which included board membership with nonprofits such as Drug-Free America and AIDs groups. We included philanthropy only when the board member had set up a foundation or program focused on ESG issues (e.g. Bill Gates of the Bill and Melinda gates Foundation) We did not include individuals making a donation to an ESG cause.

Relevant Director Experience with "G"

An issue of growing materiality, cyber/telecom security, had just eight board members with expertise. There were very few directors who had experience with ethics, transparency, corruption, and other material good governance issues. The third largest category across E, S & G and the largest in the G category was accounting oversight (G) at 2.6%. U.S. boards are required to have a least one board member with audit/finance background and most boards have at least two with that background. However, we only included board members with exhibited leadership in this area, such as being a trustee of the International Financial Reporting Standards Board or a member of the Federal Accounting Standards Advisory Board. The second largest area of expertise (1.0%) under the G was experience with regulatory bodies such the SEC or FCC.

Relevant Director Experience with "E"

Two areas of material importance to most companies and to investors, climate and water, had just five and two board members with relevant experience, respectively, across all 1188 Fortune 100 board members. In general, there is very little director expertise for the "E," with all nine categories at approximately 1%. The largest showings, at 1.2% (or 14 individuals) each, were in energy and land/conservation. The experience in energy generally came from people who had background in renewables, nuclear power and utilities, and in land/conservation, individuals who sat on conservation boards such as the Nature Conservancy. A few had public policy and/or regulatory experience. Although energy is a relevant issue for most companies, it was generally only energy companies that hadpeople with energy expertise on their boards.

Are Today's Boards Fit for Today's Challenges and Opportunities?

The Sustainable Accounting Standards Board (SASB), has identified ESG issues that provide material financial risk by sector, so we were interested to explore if sectors vary in their board member' ESG credentials.

We found that Health Care: Pharmaceuticals, Biotechnology & Life Sciences; Utilities; Consumer Staples: Household & Personal Products; and Telecommunication Services had the highest percentage of board members with relevant ESG credentials at 55, 50, 46 and 46% respectively. However, while Health Care: Pharmaceuticals, Biotechnology & Life Sciences had 53% of members with S credentials, only five had health related credentials. And, despite the significant environmental footprint (energy, water, waste) and governance issues (opioids, biotech, drug access) zero board members had environmental credentials and just 4% (two) had governance credentials.

The sectors with the lowest ESG relevant representation were Consumer Discretionary: Media; Consumer Discretionary: Retailing; and Industrials: Transportation with 12, 13 and 18% respectively. In Industrials: Transportation, which has significant environmental challenges (climate change resiliency, energy use, changing regulatory environment on carbon), there was only one of 66 board members with environmental credentials.

In Consumer Discretionary: Media, which has growing issues around data privacy and cyber security, among other material governance issues, only one person of 42 had governance credentials, and in Consumer Discretionary: Retailing, where employee turnover and productivity is a material issue, only 10 of 69 had social credentials.

Overall, industries with material environmental issues did not reflect that materiality on their boards. For example, Consumer Discretionary: Consumer Durables & Apparel had no board member with environmental credentials (0 of 13) despite the sector's large energy, waste and water footprint and Health Care: Health Care Equipment & Services which has a similarly large environmental footprint had only 3 of 120 board members with environmental credentials. Financials: Insurance, has material risk in environmental risk exposure, and incorporation of ESG into investment management and policies related to incentivizing good behavior according to SASB (health, safety, environment) yet only 6% (11 members of 149) had relevant E credentials.

While governance issues are material to all sectors, they are especially material for finance. Financials: Diversified Financials; Financials: Banks; and Financials: Diversified Financials, had 10, 9, and 7% of board members respectively with governance credentials, this despite the fact that SASB ranks data security and business ethics as financially material issues for the sector.

A Look at Select Companies

Virtually all Fortune 100 companies are well known brands, which increases regulatory, investor, civil society and public scrutiny and the downside of ESG missteps. Looking at a few companies with material ESG exposure, we see a wide range of approaches.

Good Practice:
Dow Chemical stands out as a company that has aligned its board member expertise with its ESG exposure. To address its material environmental risks (e.g. materials, energy, water, climate) Dow has three board members with relevant "E" credentials: A member of the US Climate Action partnership, a former EPA Administrator and the Chair of the World Business Council for Sustainable Development. It also has a board member who sits on the board of Catalyst (with experience in diversity issues) and a corporate senior internal auditor and a member of the B-Team, both "G" credentials.

Poor Practice:
Amazon, which has material governance (e.g. customer privacy, cyber security), social (e.g. employee diversity, health and safety, retention) and environmental (e.g. packaging waste, energy, climate) has just two board members with relevant credentials: a former assistant to the Secretary of Energy and a former CEO of a nonprofit focused on family and community development. They are missing board members with expertise in cyber security and customer privacy issues, employee issues and broader environmental issues. (Since this analysis was completed, Amazon has added Indra Nooyi – ex-CEO of Pepsi to their board. During her tenure, the company focused extensively on ESG risks and strategy). On the other hand, Liberty Mutual (property and casualty insurance), despite significant climate risk exposure, has no board members with climate credentials, though two are affiliated with energy companies. McKesson, which has been sued as contributing to the opioid crisis by various states, and has material E (energy, materials, water), social (access to medicines, ethical clinical trials), and governance (misleading advertising, doctor "incentives") issues, has no board members with any relevant ESG credentials on their board.

Deep Dive into Corporate Responses on COVID and Racism

COVID and #Blacklivesmatter offer two real-time cases of whether boards are taking ESG and a multi-stakeholder approach seriously. We looked at a subset of 45 Fortune 100 companies to assess their responses during summer 2020.

Nearly all companies (41 out of 45) made a statement responding to the racial and social justice movement following George Floyd's death. Those that didn't — Berkshire Hathaway, Oracle, General Dynamics, and Phillips 66 — were generally in the lower ranks of ESG performers. Statements of support generally came from CEOs by name, although some companies also released general, unsigned statements and made more explicit uses of #BlackLivesMatter language.

Many companies made donations or in-kind contributions to organizations providing social services to communities of color, engaging in advocacy/policy work for equitable practices, and increased matching of employee donations.

However, stakeholders are calling for change in how the business does its business, rather than just charitable giving. In response, some companies took actions to enhance diversity, equity and inclusion (DEI) efforts with an emphasis on underrepresented groups (POC, women, veterans, etc). Nevertheless, very few made their current performance and targets public and none publicly enlisted an accountable third party to provide oversight. This is a board failure. Without transparency on current demographics and targets, progress is likely to be minimal and corporate reputations will be at risk. Alphabet provides a useful positive example—they disclosed that 4% of their executive team are minorities and they pledged to increase that to 30% by 2025.

Part of the problem: just 4.1 percent of directors in the Russell 3000 were Black in 2019 (up just .05% from 2008) (ISS 2019). Representation by women on boards has increased substantially from a few years ago, stimulated by legal requirements in California. Now California is poised to do the same on race and sexuality: The state legislature aims to require boards to have at least one minority representative by 2021 and two by 2022 (three on boards with more than nine directors). Those who qualify would self-identify as Black, Latino, Asian, Pacific Islander, Native American, Native Hawaiian or Alaska Native, or as gay, lesbian, bisexual or transgender. State Street and other large asset owners are also beginning to push boards to nominate Black representatives. Bottomline: it is difficult to see how effective antiracist policies will be implemented without board members who personally understand the depth of the problem. Corporate response to COVID from a sustainability perspective focuses on the "S" – in particular, how are workers being treated and is sacrifice shared equitably across the organization? We examined a number of corporate practices, ultimately focusing in on how the companies treated workers on the one hand, e.g. layoffs, furloughs, sick leave policies, and bonuses for workers and how they treated their C-suite, board and shareholders on the other, e.g. compensation cuts for the C-suite and board members, reduction/suspension of dividends and/or share buybacks.

So, how did boards deal with the need to support employees and share sacrifice across the organization? Sadly, we found that compensation cuts for board members were non-existent, cuts for the C-suite were rare and generally confined to salary (not options and bonuses), dividends continued, and share buybacks were reduced by some companies, but definitely not all. We should also note that this information was challenging to find and often vague, though the Just Capital COVID-19 Tracker was of great help. More transparency is needed.

Information on treatment of workers was also challenging to find. However, it appears that layoffs and furloughs were common, bonuses for frontline workers expired in early summer and sick leave policies related to COVID were limited or difficult to uncover. Companies such as United Health Care, AT&T, Chevron, Walgreens, Microsoft, IBM, and Intel announced significant layoffs, but no C-suite or board compensation cuts. Generally, they continued to pay dividends and a few, such as AT&T and Microsoft continued to issue share buybacks.

Ford and GM were interesting exceptions to the rule. There was shared sacrifice across the company: top executives deferred their pay or had 20-50% pay cuts, while some workers were furloughed at 75% pay. Share buybacks were suspended, as were dividends by Ford. GM did lay off 700 workers, while Ford did not.

So What is a Board to Do?

Understand the material ESG issues for the company, today and tomorrow. Make sure that the board understands the perspective of critical stakeholders such as workers, civil society and long-term investors on those ESG issues. Ensure their concerns are built into the culture and business strategy of the company, both in terms of risks to be managed as well as opportunities to be developed.

Diversify the board to include people with expertise in those material issues. Clearly they do not need to be climate change scientists or cyber security technicians. The board can hire that kind of specialized expertise. But without board members who have a strategic understanding of the issues, the board will not know the questions to ask or even understand that the potential risks might exist. A diverse board is also more likely to ask the right questions. PWC found that more female than male board members are likely to say that climate change and human rights should be part of business strategy, for example (PWC 2020). Most boards have a preponderance of former CEOs sitting on their boards. Those CEOs were in charge 10-20 years ago when ESG issues were not regularly considered as material and they bring that mentality to the boardroom.

Ensuing good performance on material ESG issues is now part of a board's fiduciary duty and, according to the Business Roundtable, part of the corporate purpose. Stakeholders are aligned: see CERES report, "Lead from the Top," (CERES 2015) wherein they call for recruiting board members with the right expertise, board education overall and regular engagement with stakeholders and shareholders. And don't bring on a token woman or Black or climate guru if they will have no mandate and support. Ticking the box will not accomplish much without efforts to provide an inclusive environment where board members can comfortably bring diverse perspectives and challenges to light.

Another resource for board members is "The New Paradigm," developed by a well-known lawyer, Marty Lipton, which puts forth detailed recommendations for transforming the relationship between boards of directors and investors in order to make the transition to a more stakeholder-centric, long-term focused governance structure (Lipton, M. 2019).

Earlier in 2020, the World Economic Forum issued its annual Global Threats report and identified five of the biggest threats to be environmental, with significant implications for business. After that report, COVID and racism also became clear business risks. Some are calling for a different board approach to enterprise risk management, with so much of a company's value tied up in its reputation, board members should set up a "integrated governance risk committee," and a cross-disciplinary management committee (Directors and Boards 2020).

In addition, board members should ensure that the company has a sustainability strategy that is embedded in the company's business strategy and that KPIs are developed that are aligned with key reporting standards, that are built into work plans and compensation, and that are third-party assured. Board members should also ask the executive team to report on the financial impact of their ESG investments in a comprehensive way, including intangible and tangible benefits such as risk avoidance, employee retention and operational efficiency as per models such as the NYU Stern Center forSustainable Business Return on Sustainability Investment (ROSI™).

To be competitive, to manage risk, to ensure good financial performance and to meet societal expectations, directors should reflect this new reality in the board culture, their own expertise and through proactive engagement with management on its sustainability strategy and with key stakeholders. The Business Roundtable Statement of Corporate Purpose needs to be backed up by boards who understand their responsibilities. Bringing a more considered diversity of board member experience to ESG and stakeholder management will be critical to the success of the 21st century corporation.

Methodology

The research sources were company bios and Bloomberg bios. The list of the Fortune 100 was as of March 2018 and the bios of the board members themselves were as of April 2018.

We researched all organizations listed in the bios with whom the board members had had an affiliation and as potential credentials if they were a "national" or "international" organization and if they had a significant role "i.e. board member or adviser."

Under the first cut, 508 of 1188 board members (43%) had nominal ESG credentials. 11% of 1188 served on multiple boards, so the actual number of board members with ESG credentials was 438, but that difference did not materially affect the results. Females were somewhat more likely to have ESG credentials than men as they represented just 25% of the total, but 33% of those who had ESG credentials.

43% seems extremely high, and it is, until we look more closely at the type and relevance of those credentials. We initially defined ESG credentials generously, including credentials such as serving on an inner city youth education board, even though it had no direct relevance for the social issues of the company. When assessed for relevance, the numbers dropped to 29%.

Most of the non-relevant credentials were for people serving on youth education related boards (83 dropped) or small land trust/conservation related boards (24 dropped) when they had no bearing on the business of the company. Board membership on large environmental organization boards which work with business, such as WRI, was maintained, as were youth education programs that brought students directly into the company through internships, for example.

The list of categories of ESG credentials we included are in Table 1.

For the COVID and #Blacklivesmatter research:
Using the 2019 US Fortune 100 list, research was conducted on company responses to the COVID-19 pandemic and the Black Lives Matter (BLM) movement in the aftermath of George Floyd's death on May 25, 2020. Information was collected beginning in early July and extending through mid-August 2020.

In order to provide a representative sample given time constraints, companies selected included:

1. Top 21 of the 2019 US Fortune 100 list (2019)
2. Top 10 companies according to their 2018 Sustainalytics ESG ranking*
3. Bottom 10 companies according to their 2018 Sustainalytics ESG ranking*
4. At least one company representing each industry* (i.e. "Consumer Discretionary; Automobiles & Components" or "Financials; Banks")

As defined by CSB summer 2019 research

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