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Governance of Sustainability Dialogue - ***From Climate Change to Social Change***

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Plenary 1: Board Accountability for Sustainability

- Mervyn King, Founder and Chair Emeritus, Global Reporting Initiative and Value Reporting Foundation, UK
- Mark Campanale, Carbon Tracker Initiative, UK
- Eva Halvarsson, Chief Executive, Swedish National Pension Fund, Sweden
- Chair, Richard Howitt, Strategic Advisor, Corporate Responsibility & Sustainability, Business and Human Rights, UK

Richard Howitt:
My panellists are the world's leading thinker on corporate governance, a world expert on relationships between financial risk and climate change, and the Chief Executive on one of Northern Europe's largest pension funds.

We are facing sustainability challenges from global pandemic, social inequality and climate change. Our real test is how we translate this into corporate governance. On 9th March 2021 world business leaders co-signed a letter published in worldwide international financial publications, asking for adoption of sustainable corporate governance, a 'New Paradigm'. How do existing corporate governance models act as a root cause of existing unsustainable business practices, and how can fiduciary duty and shareholder primacy be understood or reinterpreted within the stakeholder capitalism era? How can boards change towards long-term thinking and how can we introduce incentives rewarding long-term value creation for companies and the system, over short-term financial profits?

The Sustainable Stock Exchange Initiative is committed to bringing ESG requirements into listing regulations, with extraordinary success. The World Investment Forum, part of the UN family, is committed to sustainable development. There are huge challenges to achieving these objectives. The Sustainable Business Report states that 83% of today's board members do not have expertise to oversee sustainability issues. The Alliance for Corporate Transparency confirms that 85% of boards do not address sustainability issues and 4% take their sustainability strategy or report to their AGM. The World Business Council for Sustainable Development states that more than ⅔ do not link Executive remuneration to sustainability objectives.

Mervyn King is Founder and Chair Emeritus of Global Reporting Initiative and Value Reporting Foundation. He is Author of the King Corporate Governance Codes, introducing the concept of stakeholder thinking into corporate governance 20 years ago, and books, such as "Transient Caretakers" and "How Accountants Can Save the World."

Mark Campanale, of the Carbon Tracker Initiative, a climate change and financial risk expert, inventor of "Unburnable Carbon" on stranded assets and key advocate for decarbonisation of investment portfolios, in 2021, receiving the Joan Bavaria Award for Building Sustainability in Capital Markets.

Eva Halvarsson is Chief Executive of Swedish National Pension Fund, AP2. The fund now concentrates on sustainability and better long-term returns, focusing on climate, corporate governance, diversity and reporting transparency.

Mervyn, how can we get boards to be truly accountable for sustainability?

Mervyn King:
Today's boards, as individuals and collectively, must ask how the company makes money and about their business model, which should be how it creates value regarding economy, society and environment. The World Commission on Environmental Degradation's concept ran from 83 to 87, until the Brundtland 1987 statement on the integration of "The three critical dimensions for sustainable development is economy and environment." At this time, biodiversity and ecosystems covered all three dimensions.

Currently, due to human development, extinction occurs in plants, animals, microorganisms, everything. So today's boards need a collective framework in its thinking regarding creating value with constrained resources. The 2010 IR framework covered value creation and inputs, company activities, outputs and outcomes. Instead of enterprise value creation, it mentioned value creation. In the early 21st Century, Directors and thought leaders rejected shareholder primacy, which had resulted in the 20th Century's unsustainable development, using natural assets faster than nature's regeneration.

Around the Millennium, 20% of market gaps of companies consisted of balance sheet additives, according to GAAP and IFRS financial reporting standards. The GRI was formed, developing standard guidelines regarding company activities, outputs and impacts on the critical dimensions, and consequential outcomes. In the last decade, ESG experts realised the critical pillars, although integrated, were impacting LLCs in the developed and developing world, e.g. the Lehman Brothers collapse. Economically, their financial condition was impacted. Socially, the pandemic impacted LLCs, and environmentally, climate change.

Sustainability consists of a company's activities and outputs, the critical dimensions' impact, and as Chair, we still view this as Brundtland did. The GFC impacted companies, so we developed enterprise value creation. The board needs a unified collective mind, all Directors understanding the company purpose, value drivers, KPIs, key risk indicators, and knowing the pertinent SDGs embedded in the business model. To be sustainable and raise capital in the world's capital markets, companies can issue bond coupons for Asset Manager and donor bidding. They do both financial and ESG due diligence. If you have a supply chain code of conduct, what is happening in it? Have you monitored it? Asset Managers and owners know if a major supplier uses child labour, market value will decrease by 40-50% within 1-2 days.

Boards must be aware of both sides of sustainability. The SEC, who sit on the IFRS Monitoring Board, two days ago, issued a statement insisting we look at sustainability disclosures and the lessons learnt by framework providers and standards setters in this space. Working with the IFRS, I fear we may have fragmentation of International Sustainability Standards, but harmonisation is based on building blocks. The EC's Task Team issued, not Non-Financial, but Corporate Sustainability Reporting Directors. Note the change in language, companies, not individuals, are the real users of natural assets, which hugely impacts sustainability, incorporating biodiversity and ecosystems.

In recent months, corporate reporting has changed immensely. The more informed it is, the more transparent the accountability. Directors and boards should discharge their duty of accountability, in concise, not IFRS, language, the tentacles being online, the head integrated report. It is accepted worldwide that we connect financial and sustainability reporting. Hopefully, we won't have fragmented sustainability reporting standards for the EU, other countries, the US and Russia and China.

Richard Howitt:
Mark, should boards be made accountable for sustainability, and how?

Mark Campanale:
The transition to a sustainable world is forward-looking and requires an unimaginable scale of turnover in global economy, with a series of challenges. Carbon Tracker are a non-profit financial thinktank of 30 accounting professionals, Financial Modellers and Economists. President Biden announced US aims to halve emissions by 2030. The International Energy Agency recently stated avoiding 1.5° and achieving Net Zero means no new investment in coal, oil and gas expansion worldwide. Currently we spend $1 trillion on pipelines, refinery, oil and gas production and expansion. Most global economies aim for Net Zero by 2050.

We expect decarbonisation of key global economy pillars: cement, steel, construction, property sector, chemical manufacturing. Essentially, this means no more internal combustion engines, the ban announced worldwide in major cities, and ending coal fire power. The turnover, with the fossil fuel system's decline, is between $20-30 trillion of global economy assets. We expect this manufacturing system turnover to occur, very rapidly, over 20 years.

It is important to investors and markets, because we estimate around 25% of global equity market value and half of non-bank corporate debt, links to fossil fuel. We must write-down significant chunks of value of company assets, e.g., coal fire power stations, pipelines, oil rigs, replacing with cleaner alternatives, which ultimately, affects banks.

We need adequate forward-thinking reporting and disclosures for Directors and Officers. Companies dependent on oil and gas or coal, describe their business as having going concerns, or lack disclosure of tests Directors must apply for whether they have going concerns, which will end their useful economic life. Companies must ask Auditors and Accountants to do stress tests against assets expected in decarbonisation. In the context of TCFD, we see business as usual disclosures, some describing their business in a below 2° world as not needing to write-down assets, retire oil and gas reserves, change the 30 year of life of a pipeline to a ten year life, because the world is using more oil and gas. Do Directors describe the risks adequately, in an informed way, through the audit and accounting process, or because of the scale of the challenge or rely on business as usual?

This is orderly transition, the market needs information soon. If we delay asset write-downs and Directors' descriptions on the effect on chemical or steel industries, governments will impose $100 a tonne carbon prices. Transition will be disorderly, crystallised risk in prices, bond value write-down, banks stress testing lending for fossil fuels. Do our disclosure, reporting and accounting systems allow us to make forward-looking statements, to get financial markets, shareholders, banking regulators fit for the imminent challenge?

Eva Halvarsson:
People and motivation, and board focus and accountability, are important aspects for boards and Management Teams. To create successful sustainable organisations, you must continually incorporate the three Cs: commitment, culture and curiosity. With true, top-down and bottom-up commitment, much more will happen. Culture symbolises nurturing company culture, with sustainability as an important pillar in work and good ideas for advancing work coming from everyone. To recruit and retain new people, this must be evident. Curiosity means everyone, implementing full daily analysis of sustainability parameters: climate, biodiversity, human rights. Management, employees and boards must learn more and admit we don't know everything. This is not easy for everyone, but curiosity helps. Responsibility means learning more.

A recent issue with board focus and accountability is regarding separate Sustainability Committees. Some say they would like board members with specific sustainability skills to prepare board view on sustainability, which I strongly advise against. It is a core issue, too important for boards to delegate to committees, which should be discussed constantly on the board, enabling members to learn more from the specialists, hearing different perspectives, because there is no right answer. As a trained Accountant, Mervyn's book, "Accountants Can Save the World," makes me happy, but we're all responsible and can't delegate to a committee. We must work with sustainability seriously.

Richard Howitt:
Reports are agreed at board level in some cases, but our focus is advancing board accountability. As an investor, engaging with companies, how should everyone be responsible? With some companies, the sustainability strategy or report will be one of many items, it's discussed and documented, then left. Other companies integrate it in all deliberations. Eva, what do you say to companies about adapting their thinking?

Eva Halvarsson:
We've seen the whole spectrum, from transparent and knowledgeable companies, to those who are in denial. To drive development, investors need to learn more. We ask companies to describe their strategy, etc., but to challenge them, we must understand the future climate, biodiversity, human rights challenges. We see many reporting initiatives to force board disclosure on their thinking and actions, so we should be ahead on these issues. Companies are leaning back with TCFD, which is a start. One reason AP2 engages in Climate Action 100+ is to raise this with the world's largest risk companies.

Richard Howitt:
It's a group of investors who chose the major companies with climate impact, to work with them on climate transition. Mark, why is so little happening in boards? Some board members may try a bit harder, ask for a slightly better sustainability report or more staff under the Chief Sustainability Officer. How has the scale of the challenge not been met and what will make board members implement your suggestions?

Mark Campanale:
It's intriguing that it has been allowed to happen. Shareholders haven't applied the scrutiny it deserves. Carbon Tracker are one of the main data providers for Climate Action 100+ on energy transition affecting oil and gas and utility companies, producing detailed profiles, with transition pathways or strategies for every major worldwide significant listed corporation. I support the TCFD, but are companies reporting against the principles of how they were set up, and if not, why? Are they giving adequate scenarios, truly stress testing the viability of their current business models?

The Say on Climate initiative, supported by Sir Chris Hohn, activist Hedge Fund Manager, has attracted attention from worldwide institutional investors, e.g. the Chevron vote, and ExxonMobil with Engine One's 0.02% of shares managing to disrupt the board and remove and replace three incumbent Board Directors. Exxon, unlike many oil and gas sector boards, was unable to demonstrate clear, forward-looking 21st Century energy transition plan. Yesterday, IRENA stated the majority of worldwide new energy installations are renewable, the majority of which being cheaper than fossil fuels.

Asking a company like Exxon their plans now renewables are cheaper than gas and oil, let alone coal, they intend to build out more oil and gas, a shareholder would ask if the board and Directors are awake and aware of the situation. Exxon, among others, deny it is happening, and shareholders were clear in response, removing Directors, which could lead to a fundamental change at Exxon. Darren Woods, Chief Executive, says he looks forward to co-operating with the new board members. Board Directors worldwide must learn that if you can't present an adequate low carbon and decarbonisation transition plan, new Directors will be installed, who will potentially install new management, which will be common in the near future.

Richard Howitt:
Eva says institutional investors have to learn. Shareholders and shareholder activism have their role to play, Mark. Mervyn, regarding the importance of stakeholders and moving from shareholder primacy, what role do stakeholders have in company governance? How should board members interact with and understand stakeholder interests?

Mervyn King:
From 20th to 21st Century, corporate leaders wrongly believed they had to increase shareholder wealth and act in their interest, and success encompassed increased share price, dividends and profits, notwithstanding the subsidies of society and the environment. In my book launched yesterday, "The Healthy Company," it is described as a "Century of lawful wrongs," because it was accepted as lawful, but they committed wrongs.

Regarding Say on Pay, do we now need a say on stranded assets? Directors owe a duty of care to the company. They must make decisions in the long-term best interests of the company's health. If this is done right, it is right for all stakeholders. Legitimate interests, needs, expectations and concerns of stakeholders must be taken into account when making decisions, in the best interests of the company. Invariably, this decision results in some preference towards one stakeholder. For example, because fossil fuel plant and machinery isn't sustainable, particularly in EU with Corporate Sustainability Reporting Directives, by around 2040, these assets will become stranded. They need to change to renewables as the energy driver, which will take money. The board decides not to pay dividends for three years, to not disturb the debt-equity ratio, using the €500,000 a year and €1½ billion needed to change to renewables as energy driver for plant and machinery.

You'd imagine the share price would decrease, but in some cases it has gone up. BlackRock is a board which applied its mind to the company's longevity. It has a sustainable approach to its assets and know which assets will be stranded and which need to be impaired now or over the next year. They changed from fossil fuel to renewables. In discharging my duties to my beneficiaries, I can invest in the equity of that company.

Asset Managers and owners play a huge role and Directors' duty of care is critical. They owe it to the company. The artificial, incapacitated person has no heart, mind, soul or conscience. The heart, mind, soul and conscience of its corporate leaders are critical. When things go wrong, society turns against the company. The company is always innocent. It should turn against its corporate leaders, who have a clear, long-term duty to look at the balance sheet and ask which of the assets will, in future, be stranded assets. Those who fail are liable to accompanying damages. They failed in their duty of care to the company.

I have an accreditation course for Accountants in many countries. Barry Melancon, President and Chief Executive of ARCPA, and I, will talk on 18th November on the need to move Accountants' training from Financial to Value Officers. They must understand value creation processes, preservation and erosion. Those not looking at assets which can be stranded are failing in their duty of care to the company. From the side of providing capital, you must review company balance sheets and ask Directors about plant and machinery driven by coal power, stating your problems regarding the impairment. Either by regulation or with worldwide harmonisation of sustainability standards, it will become a stranded asset, your beneficiary's money invested in a company with stranded assets. Capital markets are now playing a huge role in Directors' thinking.

The board has to act in the best long-term interests of the company's health, taking account of the needs, interests, expectations and concerns of stakeholders. Stakeholders must take account of company needs. Stakeholder capitalism is an unfortunate term, because if Directors must act in stakeholders' best interests, the company will go bankrupt in meeting these interests, etc. The decision must be for the best outcome for the company, invariably resulting in trade-offs between stakeholders. In fairness, the board must learn and understand the needs, interests, expectations and concerns of stakeholders, especially with concerns resulting from the pandemic, for companies and stakeholders.

Long-term duty on evaluating future stranded assets has to be a board driver and capital markets will drive and compel boards to focus on this. Boards must make decisions based on financial, environmental, social and quality of governance, not simply business judgment calls, to evaluate what external stakeholders see. We need to see the four major outcomes for good governance: sustainable value creation, adequate, effective, internal controls, long-term trust and confidence in the company, legitimate operations. Without this perception from external stakeholders, quality governance isn't practised. Just having Nominations Committees and Remunerations Committees is not good governance.

Richard Howitt:
Eva, your comments, please, on how boards involve stakeholders? Do existing Directors' duties within corporate governance frameworks allow for this change of mindset or should we formally change Directors' duties?

Eva Halvarsson:
Ten years ago, on most boards there were discussions that sustainability couldn't be part of board fiduciary duty. Now, it is the opposite. Not looking into these issues is a breach of fiduciary duty. You need many different perspectives when deciding on company strategy, and putting focus on risks for stranded assets is very high on the agenda.

The Sustainable Development Goals are important eye-openers for many boards, Management Teams, etc. They were originally aimed at states, but you could observe your company and how your actions relate to the SDGs. When reporting on stranded asset risks and how your work relates to SDGs, this underlines your understanding of your stakeholders.

Fiduciary duty should take consideration of sustainability issue, but not all sustainable actions create decent returns. Boards should discuss between themselves and with shareholders if they can compromise returns. Giving out dividends is not compromising returns; it is a transition of strategy. But with stakeholders, many want the companies to focus more on sustainability than creating shareholder value.

Richard Howitt:
There is a lot of support for changing financial analysis, Mark. What is your view on the previous question?

Mark Campanale:
You can reinterpret within existing frameworks. New legislation is not necessary. Just understand the task at hand. In reality, it doesn't mean a shareholder value decline or change of duties and responsibilities, but suspending dividends for three years to raise the capital to re-engineer your enterprise and starting depreciation of the fixed assets of the fossil fuel economy, will require agreement from all stakeholders, e.g., workforce, governments and shareholders.

Carbon Tracker believes in a transition plan for every major company hoping to achieve Net Zero, which needs management and board support, but importantly, key stakeholders. It must be well prepared and presented to stakeholders and requires disclosures and descriptions required by the TCFD. With Exxon, not solely Engine One, but other shareholder activists were presenting for backing an alternative business plan, outlining Exxon's path and their alternative path. Instead, over the next few years, we need incumbent Directors and Officers preparing, at shareholders' request, transition strategies, avoiding these battles caused by incumbent resistance and slowness. The Accountants and Auditors must ensure adequate information, e.g., regarding asset depreciation, is delivered hastily. Companies must provide proper scenarios of transition risks. The market must understand the opportunities, but also costs and balance sheets entailed within this transition.

Richard Howitt:
Is it regulators, investors or shareholders forcing this?

Mark Campanale:
A lot has been written recently and at this juncture, markets and investors are moving faster than government. Investors don't wait to be told what to do or for governments to act, because of the duty of care of pension funds towards members, ensuring benefits are paid 20/30 years into the future, making corporate and financial market sustainability crucial. Climate Action 100+, a $57 trillion coalition created in three years, the biggest coalition of investors ever of its scale, illustrates the keenness for fiduciaries and institutional investors to do something, because the planet won't wait for governments to act. They must act in their own interests and those of the beneficiaries. Normally, it's the opposite, governments act first, corporates follow, but here market moves first.

Richard Howitt:
In corporate governance in the next couple of years, what one thing could be introduced or changed to make sustainability more visible and effective?

Eva Halvarsson:
We are moving ahead with transparency. Transparency and knowledge are key areas. But in Sweden, we work differently with corporate governance when appointing board members, etc., and I would like to see that in our global holdings, with largest shareholders making proposals at AGMs with board members, not just boards putting forward new members. We need new perspectives on boards.

Mervyn King:
As I stated earlier, the King IV Report discusses four outcomes, which if achieved, the external stakeholder can rationally draw a conclusion in practising quality governance. Directors must move away from a mindless checklist approach to governance, to a mindful outcomes-based approach. SDGs have become outcomes-based. Therefore, corporate governance should be outcomes-based, to fit the narrative.

I'm working with Professor Watchman at Edinburgh and UNCTAD on ESG law firms and how many of them are really practitioners of ESG and understand and can advise their clients on their ESG duty of care. For years, they have advised in the paradigm of the primacy of shareholders and this must change. Directors and Managers seek advice from Lawyers and Accountants. Teaching in accountancy and law is changing and I formed the Good Governance Academy, to combined SDG-4 (quality education) and SDG-17 (collaboration).

Not every country teaches accountancy the same. In Australia, one university teaches philosophy, because artificial intelligence will take over posting of debits and credits and they're taking an advisory role and reviewing. They no longer post data. They are reviewers and the true changemakers in the C-Suite. Solicitors must also ensure they understand the ESG issues and it must be aligned. Advisors must advise clients accordingly on duty of care.

Mark Campanale:
We must decarbonise exchanges from markets and equity markets. In the last decade, there were around 2,500 coal, oil and gas IPOs or secondary placements in public markets, raising 700 billion. Fossil fuel companies are queuing to raise capital on exchanges, and governments of fossil-fuel producing nations use bond markets to raise capital. Pension funds and investment institutions provide money and attempt to persuade them to decarbonise, but we should be decarbonising exchanges. The infrastructure of the markets need to decarbonise and create higher barriers to entry, through tougher disclosure standards and the prospectus and exchange admissions process, to question stranded allowances offloading redundant business models onto markets and investors. Due to passive indices, passive buyers buy the companies, e.g., BlackRock and Vanguard investing in fossil fuels. We must import a clear sustainable markets framework around exchanges. The Sustainable Stock Exchanges Initiative is great, but we need more ambition with Decarbonisation Goals.

Richard Howitt:
In conclusion, we must move away from shareholder primacy, stakeholders are crucial and there are trade-offs. We must have a mindful, outcomes-based approach to corporate governance. The current financial analysis is very unsatisfactory. There are real questions about companies today that are supposedly going, concerns, which are not, and the transition pathway is crucial for all companies, not just energy companies. Companies will be under increasing shareholder scrutiny. Whether this be individual shareholder activism or collaborations between institutional investors, we need sweeping change to boards and more say on board appointments in relation to sustainability.

There is a duty of care of investors, of pension plans, and the role of institutional investors in moving to a sustainable future. Whole exchanges should be decarbonising their assets, not just companies. Investors can't pour money into fossil fuel dependent business and try to persuade them otherwise.