

ESG Oversight Framework for Directors

Demystifying ESG for Board Members

Key Takeaways

- In 2017, we called on boards to incorporate sustainability into long-term company strategy. Over the past three years we have seen some progress, in that directors now acknowledge the importance of environmental, social and governance (ESG) issues to the business.
- During engagements, however, we sense some ambivalence about the board's role in overseeing ESG. Directors are seeking more guidance about what to focus on and what actions to take.
- In response, we have developed guidance designed to help boards prioritize ESG within their organizations, including:
 - State Street Global Advisors' approach to contextualizing ESG issues within the current board oversight framework
 - R-Factor™, our transparent ESG score that measures the performance of your company's business operations and governance as it relates to financially material ESG issues facing your industry
 - Our ESG oversight framework for directors that can serve as a road map for what actions are needed to further integrate sustainability into long-term strategy
- Board members have a critical role to play as catalysts for change on ESG issues. We look forward to engaging with you in the coming year to build stronger companies and capital markets.

Introduction

Over the past three years, there has been a noticeable change in directors' recognition of the importance of sustainability or ESG issues to investors. When we first called on boards to incorporate sustainability into long-term strategy in 2017, only a few companies, mainly in Europe, could demonstrate that they had considered ESG in their strategy. A majority of companies were either not focused on ESG, or were considering it only in their communications with a broader set of stakeholders.

Today, companies have begun to acknowledge the importance of ESG to their investors and boards are getting more involved in overseeing ESG. Meanwhile, directors continue to seek clarity on which issues are financially material to their business and want to understand investor expectations of the board's role in overseeing ESG issues. Some of the reasons for these changes include:

- Clearer understanding of climate change as a risk facing all companies globally
- Growing awareness that intangible issues such as human capital and corporate culture are long-term value drivers that need to be managed
- Growing customer and societal expectations for purpose-driven companies
- The growth of ESG investing, which considers a company's ESG profile in the investment process and allocates capital accordingly

Current State of Play: Director Ambivalence Related to their Role in Overseeing ESG

We have engaged with about 400 companies globally on this topic since 2017. Unfortunately companies have made only marginal progress incorporating sustainability into strategy. We rank fewer than 25 percent of the companies we have evaluated as “tier 1” companies that have meaningfully identified, incorporated and disclosed material ESG issues into their long-term strategy. Clearly, more action is needed.

Through our engagements, we have found increased appetite among directors for greater board action in overseeing the ESG issues facing their companies.

Many directors look to their company’s sustainability report (if one exists) for comfort that action is being taken on ESG issues. Yet these reports have historically been used to communicate with a broader set of stakeholders on a range of issues, not all of which may be financially material to investors. As a result, directors are left grappling with which issues matter to investors and how they relate to long-term value creation. Even companies that have long been engaging with stakeholders on sustainability issues often cannot clearly articulate how they have developed ESG-aware business strategies.

Need to Focus on Financial Materiality

At State Street Global Advisors, we take a fiduciary perspective to focus on the subset of financially material ESG issues relevant to a company’s business strategy and operations, as these can meaningfully impact long-term value creation. This allows us to have richer conversations with board members. During engagements, we seek to understand how boards are developing ESG-aware strategies, as well as how they are overseeing and incentivizing management to consider and measure performance of financially material ESG issues.

Adopting a similar focus on financial materiality would allow directors to better understand and address investors’ concerns on ESG issues. This perspective will offer clarity to directors on their role in overseeing and responding to investors on these issues.

Getting Started: Contextualizing ESG Issues in the Current Board Oversight Framework

We have found that directors typically welcome guidance about where to begin and what to focus on when it comes to ESG. But before a board can take action on financially material ESG issues, directors must understand how an issue is relevant to a company’s strategy, its business operations or both. Below, we share our approach, which adapts current board practices for overseeing more conventional issues to ESG issues. The approach considers ESG from two perspectives: strategic and operational.

ESG as a Strategic Consideration

We believe that the impact of some ESG issues on the business needs to be evaluated using scenario planning tools, the outputs of which should inform the company’s long-term strategy. This is similar to the way a board, in its strategy-setting process, considers how changes in policy with regard to tariffs or interest rates might influence the business environment. The board would then develop business strategy informed by the anticipated outcome.

The same is true for ESG. For example, considering climate change in its strategic planning process could result in a company choosing a different location for a plant to mitigate the physical impacts of climate change. Alternatively, based on different carbon price assumptions, a company could allocate capital to renewable energy projects or invest in the greening of existing infrastructure.

Another example might be a company's public commitment to gender diversity or human rights. In this case, as part of the due diligence process, boards might need to consider not only the practices of a potential acquisition target but also potential impacts on the assumed synergies as a result of those practices.

ESG as an Operational Consideration

Financially material ESG issues are also deeply embedded within a company's business operations. These issues, if not managed and overseen appropriately, can negatively impact company performance. Complicating matters is that it is not always obvious which ESG issues — or which dimensions of those issues — are financially material to the business.

For example, a pharmaceutical company might, as part of routine business practices, monitor the marketing and selling practices for its products with revenue objectives in mind. But a comprehensive ESG approach to that issue would also look at the impacts of such practices on public health. In the wake of the opioid crisis, for many pharmaceutical companies, the lack of focus on this aspect has increased regulatory costs and called into question the companies' social license to operate.

It is important to acknowledge that investors themselves do not always fully appreciate the broader dimensions of ESG risks facing companies either — or fully credit those that effectively manage and mitigate these risks. Therefore, we believe it is important for companies to identify, manage and publicly disclose what they consider to be financially material ESG issues. Increasingly, companies are leveraging the [Sustainability Accounting Standards Board \(SASB\)](#) disclosure framework, which is supported by global investors, to guide their public reporting.

When companies consistently disclose ESG information, it allows investors to compare and reward companies with strong performance in these areas. Additionally, we have found that directors who have contextualized ESG from both a strategic and business operations perspective tend to be better equipped to communicate these issues to investors.

Measuring a Company's Operational ESG Performance: Introducing R-Factor

At State Street, we recognize that investors require the ability to measure a company's ESG performance. This is why in April 2019 we launched R-Factor, a transparent ESG scoring system that measures the performance of a company's business operations and governance as it relates to financially material ESG issues facing the company's industry.

Drawing on data from four ESG data providers and leveraging the materiality framework established by SASB, as well as relevant corporate governance codes, R-Factor generates unique ESG scores for over 6,000 listed companies globally and allows us to evaluate a company's ESG performance against both regional and global industry peers.

We selected SASB as the basis for the majority of R-Factor scores because it offers an industry-specific ESG disclosure framework that is laser focused on financial materiality and is designed for investors. Moreover, SASB is supported by global investors representing \$33T in assets, and since the launch of the SASB standards in November 2018, is quickly becoming the preferred ESG disclosure framework for investors. We view SASB as a minimum ESG disclosure standard, upon which companies can build based on the specific needs of their business and stakeholders.

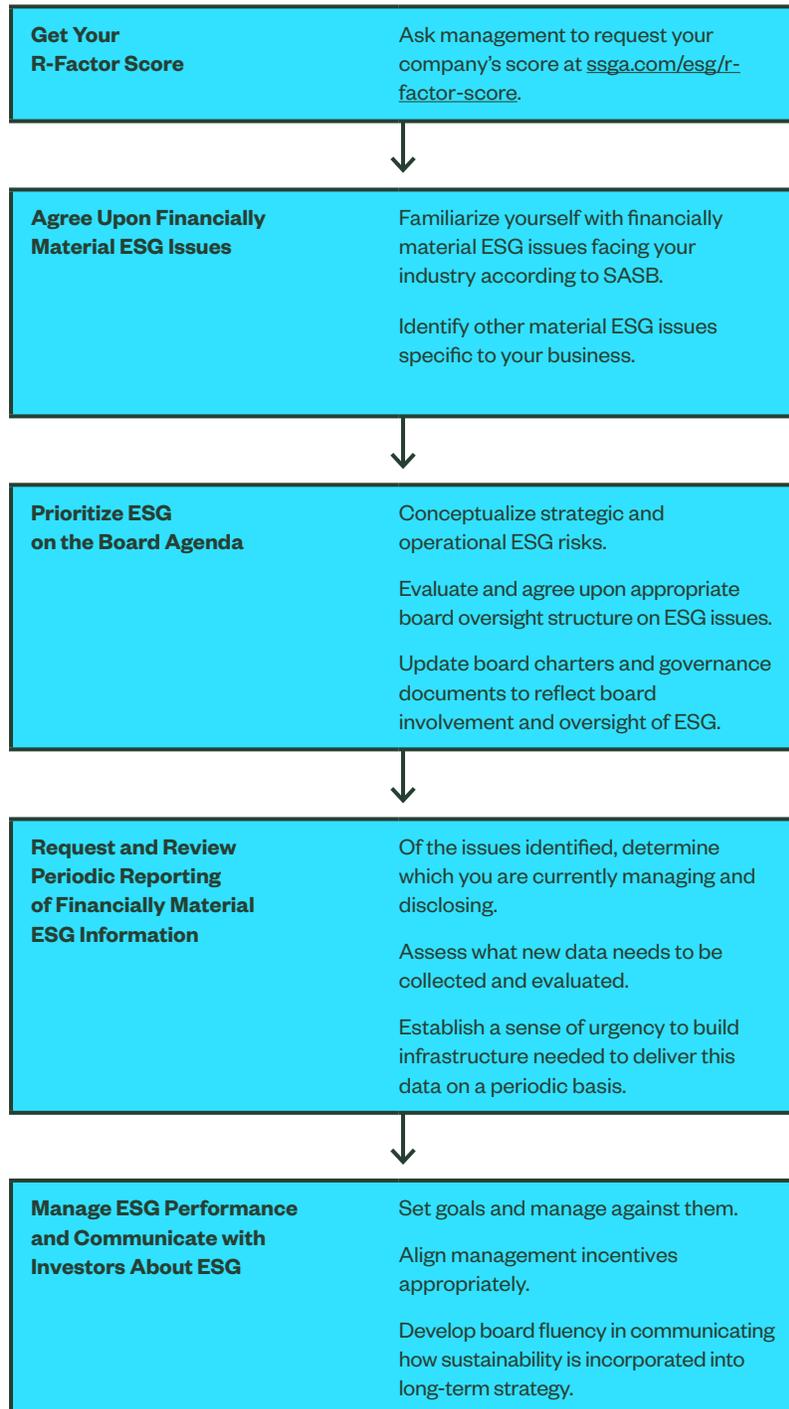
Getting Your R-Factor Score

As part of our engagement with companies, we are making R-Factor scores available to company management. As of December 31, 2019, more than 130 companies have requested their scores and are sharing them with senior management and their boards. If you have not already seen your score, we suggest that your management request at ssga.com/esg/r-factor-score.

Along with your company's score, we send the scores of your industry peers at the regional and global level, in order to offer insights into your comparative ESG performance. We also provide further details about SASB and your corporate governance code. Armed with this information, you can begin making the changes needed in your company to more holistically address ESG from a strategic and operational perspective.

**Taking Action:
State Street Global
Advisors' ESG
Oversight Framework
for Directors**

There are many ways for boards to oversee ESG issues. Below we provide a suggested framework that can help directors interested in prioritizing ESG at the board level.



Conclusion

In the coming year, we expect that ESG will become a mainstream boardroom issue, resulting in companies improving their ESG infrastructure and disclosure. However, investors and companies alike are still in the early days of understanding and managing the risks and opportunities that ESG poses to businesses and economies. The fluid and quickly evolving nature of the ESG landscape often makes it difficult for directors to take appropriate action on ESG. Over the course of three years, we have found few companies that have fully incorporated ESG into their strategy and operations.

We call on companies to build the disclosure and reporting infrastructure and develop the management tools that are needed for effective board oversight of ESG issues. We suggest focusing on financially material ESG issues that are relevant to long-term value creation to gain insights into the investor perspective. By highlighting similarities to more traditional board oversight frameworks, we have proposed an approach that contextualizes ESG as a strategic and operational issue that needs to be overseen and managed. Finally, our ESG board oversight framework is designed to give directors a road map that will allow for the creation of ESG-aware business strategies.

Prioritizing ESG within an organization requires concerted effort from the top, and board members have a critical role to play as catalysts for change. We look forward to engaging with you on this matter and partnering with you in the coming year to build stronger companies and capital markets.

About State Street Global Advisors

Our clients are the world's governments, institutions and financial advisors. To help them achieve their financial goals, we live our guiding principles each and every day:

- Start with rigor
- Build from breadth
- Invest as stewards
- Invent the future

For four decades, these principles have helped us be the quiet power in a tumultuous investing world, helping millions of people secure their financial futures. This takes each of our employees in 27 offices around the world, and a firm-wide conviction that we can always do it better. As a result, we are the world's third-largest asset manager with US \$2.95 trillion* under our care.

* AUM reflects approximately \$43.96 billion USD (as of September 30, 2019), with respect to which State Street Global Advisors Funds Distributors, LLC (SSGA FD) serves as marketing agent; SSGA FD and State Street Global Advisors are affiliated.

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