European boards and sustainability: Charting the green recovery

Boards can help their companies blend profit and purpose seamlessly into their strategies by focusing first on their own purpose, composition, and processes.

As the economy has been going green, sector by sector and company by company, the pressure to act on sustainability issues is mounting on European boards every day, with governments, investors, consumers, and employees alike demanding a stronger and more urgent response to the climate crisis. Many business leaders now understand that they don't need a sustainability strategy—they need one sustainable business strategy that integrates resilience and performance into an economic transition where investors, policy makers, and consumers are increasingly aligning around net-zero carbon emission goals. Over the past 10 to 15 years, sustainability issues have picked up speed, a trend that will only continue to grow. Entire sectors are transitioning; we are witnessing the decarbonization of power with the continued growth of renewable energy, the shift to electric vehicles, and increased developments in biodegradable plastics and plant-based foods. The exponential growth of these sectors is driven by sustainability. Sustainability is fundamentally changing the game, and the board members of many businesses across the world are asking themselves searching questions about the sustainability and resilience of their company's business models.

Following the money (in this case the capital markets), it all points in the same direction: banks are investing in their own green products portfolios and investment companies and credit agencies are mandating greater transparency and disclosure across environmental, social, and governance (ESG) metrics. In his 2021 annual letter, Larry Fink, BlackRock's CEO, points out that the reallocation of capital toward sustainability accelerated faster than he anticipated, in what he sees as an increasingly faster-paced transition toward a new economy landscape shaped by green investment strategies.[1]

1 Larry Fink, "Larry Fink's 2021 letter to CEOs," BlackRock, January 26, 2021, blackrock.com.

While there is widespread generic awareness about the urgency of dealing with climate change and many companies have progressed significantly on their sustainability strategies, leaders are still catching up with political, investor, and consumer sentiment. Fascinatingly, according to a recent PwC survey of directors, 31% of those surveyed felt that there was too much time spent on sustainability on their agenda.[2] This is in stark contrast with our recent experience in working with boards and executive teams, where there is increasing recognition that sustainability is synonymous with group strategy, decisions on operating model, access to capital, and near-term business resilience.

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Although every board will have a different starting point and view the future through a different lens, we believe that there are three things every board needs to do to effectively embed sustainability into its thinking and processes: its members must live their organizational purpose as a team, build a sustainability-savvy board, and set themselves up for success through the way they operate.

The road map to net-zero is the path to growth

Today there is a clear convergence of pressure on companies to focus on a sustainable path, starting with the clear evidence that a growing number of consumers are showing a preference for sustainability-friendly products and companies cannot afford to alienate them; Nielsen research has found that 73% of consumers say they would definitely change their consumption habits to reduce their environment impact.

And finally, as scientific evidence of climate change impact mounts, governments have become more and more focused on the growth post-COVID-19, with stimulus packages focused heavily on a "green recovery." The stakes will be even higher as we anticipate the outcomes of the UN Climate Change Conference in Glasgow in November. Countries including Denmark, France, Hungary, Sweden, and the United Kingdom already have legally binding net-zero targets, and many others in Europe are likely to follow. Importantly, China's pledge of carbon neutrality by 2020 and United States rejoining the Paris Agreement has added to the momentum and the hopes of many that governments, business, and global society can reach the 2050 net-zero target.

Sustainability has been an issue for European boards for more than 20 years, so what is new this time? This year's *Corporate Knights'* annual ranking of the global top 100 sustainable companies included 46 European companies from a variety of sectors such as energy, consumer goods, financial services, chemicals, construction, pharma, and others, which is a clear result of the journey many companies in Europe have been on over the past two or three decades.[3] But though the awareness that businesses are expected to play a critical role in safeguarding our planet and people has been growing, many boards and executive teams are still grappling with the implications of the increasingly forensic focus on companies to step up and are struggling to formulate their best response. An increasing number of companies have made net-zero pledges, with companies such as Apple, BP, IKEA, and Microsoft leading the way, thereby piling pressure on their competitors. However, out of the hundreds of companies that committed to net-zero carbon goals, only 1 in 10 such business pledges are backed by science-based targets, and only half have clear milestones on how they will achieve carbon neutrality.[4] Fascinatingly, in our recent chair roundtables, it is chairs themselves who are questioning whether we are sufficiently ambitious or moving fast enough. In addition, there is a converging view that while individual company responses are a good start, only a coordinated, government-led response and greater cohesion from investors as to their priorities and metrics will allow companies to deliver their part in achieving net zero.

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But despite the rhetoric and the relative uncertainty of the road map, chairs must continue to provide leadership in sustainability—either individually or, even better, collectively—to meet the challenge and the demands of all their stakeholders.

2 *2020 Annual Corporate Directors Survey*, PwC, September 2020, pwc.com.

3 Mike Scott, "The 2021 Global 100: How the world's most sustainable companies outperform," *Corporate Knights*, January 25, 2021, corporateknights.com.

4 Ben Chapman, "Only one in 10 companies' net-zero pledges backed by science-based targets, report finds," *The Independent*, November 24, 2020, independent.co.uk.

Redefining the board's shared purpose

One of the most important shifts a board has to go through is tipping the balance of decision making toward prioritizing the long term. It must also understand how its focus on sustainability will redefine its priorities. One former CEO and current board member we spoke with said, "Going forward, doing well and doing good will have to go hand in hand. It wasn't always the case, but it's proven that it can work, and in the future, it has to be a must." Crucial for those going through this process is keeping their eyes firmly on the horizon while at the same time dealing with the ESG disclosure and compliance that will bring them closer to sustainable growth.

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Blending purpose, sustainability, and profit into one strategy is where boards can wield their influence for the greatest impact. A senior investor we spoke with said, "If you have a separate corporate strategy from your sustainability strategy, you are missing the point." Every important decision boards make should have a sustainability component: a built-in assessment of how strategic decisions will affect the environmental and social impact of the business.

The view that all board decisions should be closely aligned to organizational purpose is not new, but it is growing. A recent Heidrick & Struggles study found that most European board members believe that embedding a purpose-driven culture will significantly increase in importance on board agendas within five years' time and that they will be spending significantly more time on purpose.[5] This is another important shift, as our research on organizational acceleration found that purpose has significant impact on performance: purpose energizes leaders by providing them with the opportunity to inspire employees and make everyone feel as if they're working toward some greater good, and, at the same time, energizing leadership has a clear, positive impact on organizational performance. We found that companies that score high on energizing leadership have twice the performance ratings of organizations with low acceleration scores.[6]

Sustainability offers an opportunity for authentic leadership, where leaders' behavior demonstrates their true commitment to the company's purpose. It is essential in rallying everyone in the organization and, at the same time, builds trust with external stakeholders. As many businesses redefine their purpose to emphasize sustainability, board members need to incorporate these changes into a shared purpose that guides their decisions. Importantly, the value of sustainability is reflected in a common language, where all board members understand and value sustainability to the same extent. This can present a challenge for some boards whose members span multiple generations and schools of thought, but, as one of the CEOs we talked to observed, it should not be an unsurmountable one: "Our board probably needed to take the biggest leap, as they represent different generations, but they have endorsed the new purpose and strategy and have supported our communications and engagement plans."

5 Jamie Page, "Board of the future: Moving toward a more diverse, more in tune European board," Heidrick & Struggles, March 2, 2020, heidrick.com.

6 Alice Breeden, Rose Gailey, and Duncan Wardley, "Activating organizational purpose," Heidrick & Struggles, June 29, 2020, heidrick.com.

Building a sustainability-savvy board

As sustainability has become more central to strategy, boards must carefully ponder how they can equip themselves with the necessary acumen to make decisions in the best interest of their companies.[7]

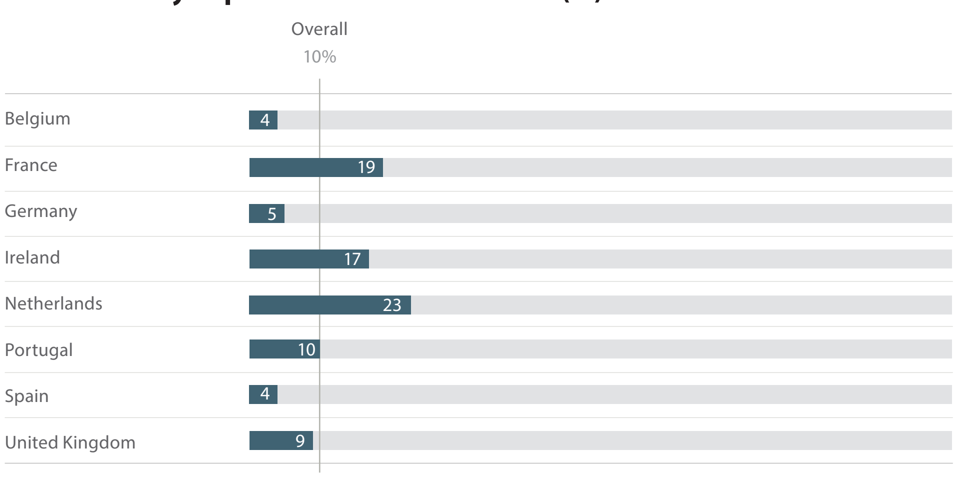
All directors should have a foundational knowledge that will allow them to make informed decisions on both sustainability-specific matters and other strategic issues that have ESG implications.

The first step is to understand how sustainability affects each aspect of the business, from strategy to product development and value chain, and, in turn, how their business impacts their communities in terms of the environmental impact, employment opportunities, or access to resources. Each board will have to follow their own transition process, depending on their objectives, current composition, and governance, as well as find a common language in which all board members are proficient. All directors should have a foundational knowledge that will allow them to make informed decisions on both sustainability-specific matters and other strategic issues that have ESG implications.

This foundational knowledge should have a sector-specific focus because each industry has different challenges and pathways toward sustainable growth and should be aiming to address the uneven impact they have on the environment and society. For instance, a recent McKinsey study found that while the energy sector is one the biggest contributors to European carbon emissions, it is also one of the most likely to reach its reduction targets early if renewable energy production is amplified at the same time as the traditional oil and gas industry is decarbonized, through a combination of rapid new technology adoption, capital reallocation, and an organizational paradigm shift.[8] Sectors like consumer goods and retail might have a smaller carbon footprint at first glance, but their challenge is in transforming entire supply chains, ensuring sustainable manufacturing practices, enriching their communities, reducing transport emissions, and investing in eco-friendly packaging, among others. Sector-specific understanding of how sustainability factors into their business strategy is necessary for all boards to be able to make the right decisions when allocating investments, assessing their business impact, choosing ethical partners, and adopting new technologies. Directors should also be able to advocate for the company's approach to sustainability to investors and shareholders in a knowledgeable manner. For all board members, there are many options to build the right knowledge, such as company-specific development programs, executive education, conferences, advisors or advisory boards, networking, and even taking on non-executive roles on boards of non-governmental organizations.

However, in the current business climate, having a foundational understanding at board level about sustainability is not sufficient, because an increasing number of companies are making public pledges that require swift action or else risk remaining unfulfilled and damaging the company's reputation. Even so, our *Board Monitor Europe 2020* report found that only 10% of new directors appointed in 2019 to the boards of the publicly listed companies in the largest European markets had some level of sustainability background, with vast differences among countries: in the Netherlands, 23% of new AEX 25 board members have a sustainability background, while in Belgium and Spain, only 4% of new directors have the experience.[9]

Sustainability experience across countries (%)



7 For more on how boards may need to rethink their refreshment processes and timelines to add new expertise, see Alice Breeden, Theodore L. Dysart, and David Hui, "Building the foundation for better board refreshment," Heidrick & Struggles, January 7, 2021, heidrick.com.

8 Paolo d'Aprile, Hauke Engel, Stefan Helmcke, Solveigh Hieronimus, Tomas Nauclér, Dickon Pinner, Godart van Gendt, Daan Walter, and Maaike Witteveen, "How the European Union could achieve net-zero emissions at net-zero cost," McKinsey & Company, December 3, 2020, mckinsey.com.

9 *Board Monitor Europe 2020*, Heidrick & Struggles, September 22, 2020, heidrick.com.

This leaves a lot of space for improvement, and so, a second step for many boards is to consider the in-depth sustainability skill sets and experiences that will be most useful. Some boards opt for functional experience from individuals who have held sustainability leadership roles or responsibilities, such as former chief sustainability officers, or a regional or practice equivalent. Others look for individuals with strong ESG track records in roles that can influence the ESG agenda, such as procurement, investment, auditing, or reporting. Still others prefer to look for senior executives who have run businesses with strong sustainability components, heads of smaller but innovative ESG companies, senior executives from nonprofit organizations, senior government officials, or academics with a deep understanding of the issues most relevant to their organizations. More recently, we have observed an increased demand for profiles of non-executive directors with sustainability backgrounds that include expertise in the following four areas:

- **Capital allocation and resource management:** Reaching net-zero goals requires significant investment and a thorough review of how companies balance investments and returns in different areas of their business.
- **A deep understanding of policy:** Because climate policies and regulations are changing rapidly to address the climate emergency, this particular skill set can differ from sector to sector, depending on the issues that are material to each particular business.
- **Product innovation:** All pathways towards net-zero carbon targets will likely require a rethink of how products need to be designed in order to meet the demands of sustainability-conscious consumers and local regulators.
- **Community and stakeholder engagement:** In order to preserve their social license to operate, companies must build strong, trust-based relationships with their local communities across their value chains and bring all their stakeholders with them on the path toward net-zero goals.

It is important to note that, as with any area of expert knowledge, adding a director with a sustainability background shouldn't mean hiring a single-issue expert: any director should still have a broad understanding of the business so that he or she can helpfully participate in all board matters.

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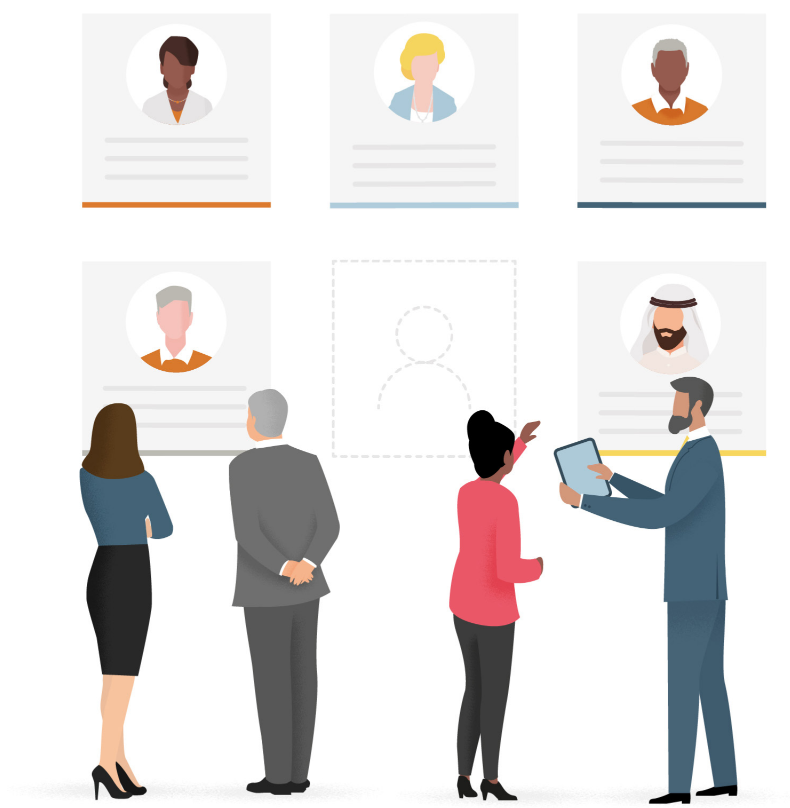

Setting up for success

Integrating sustainability into the board's wider decision-making framework starts with a materiality assessment in which the board determines the extent to which each ESG factor matters to their business, investors, and wider stakeholders.

Once boards have a shared understanding of the issues, they can make sure that they have the right tools and data to deliberate on what is most important; set realistic but stretching goals, objectives, and metrics; and assess how their executives are leading progress toward targets. The role of the board is to make sure that such zero-carbon and other sustainability pledges are broken down into short-, medium-, and long-term goals with clear accountability, with ESG performance impacting executive compensation. Part of setting meaningful goals will be ensuring the board has a clear understanding of not only what the company wants to achieve but also where it currently stands. Asking some foundational questions about capabilities, targets, tools, and dynamics will go a long way toward integrating sustainability into board decisions effectively (see sidebar, "Five aspects of board performance on sustainability").

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This seamless integration into board thinking and process has to be extended to committees, where a lot of specific groundwork is being made in areas such as audit, remuneration, nomination, and risk. The audit committee has oversight over financial reporting, audit, internal controls, and, (unless there is a risk committee), risk management. Unless ESGs factors are included in a company's financial reporting and materiality assessments, sustainability is not truly embedded in the company's strategy and operating model. It is therefore vital that the audit committee keeps sustainability and its implications at the forefront of its audit and reporting, financial and nonfinancial. The other factor to consider is the growing regulatory demands on sustainability disclosures that have now moved from optional to mandatory and now rest with the audit committee.

The remuneration committee is yet another place where sustainability should play an important role, as a company with a sustainability-driven strategy should factor in ESG targets in its rewards and incentives. A recent study shows that for FTSE 100 companies, performance-related pay for CEOs is primarily based on financial returns to shareholders rather than their response to wider shareholder needs, and while including ESG targets in CEOs' pay plans has increased for some companies, those are the exception rather than the rule.[10] But that is set to change in the next few years; a study published in December 2020 showed that 4 out of 5 companies are planning to align executive compensation with ESG results.[11]

As boards take a more proactive role in sustainability initiatives, they might also have to redefine roles and accountability boundaries with executive teams. Our *Route to the Top 2020* report shows that CEOs see sustainability as one of the key areas shaping their role,[12] and it is, of course, important to make sure that boards and executive teams work together to achieve their organization's goals.

Boards will also have better success establishing sustainability as an integral part of strategy by communicating the rationale for it clearly and frequently to all stakeholders, taking them along on the journey rather than presenting them with nearly final decisions. Influencing current investors continues to be a challenging aspect of sustainability engagement for many boards. Even though many investors have made big statements on sustainability, some less often back up those statements with their own money. Furthermore, some less forward-looking activist shareholders see corporate sustainability as a sign of greenwashing and misalignment, which reinforces the need to have a single integrated strategy in which sustainability considerations are addressed.[13] Some boards may choose to proactively seek investors who share their commitment to sustainability and understand the short-term risks of the trade-offs that have to be made for long-term success.

Transparency is also essential in boards' engagement with employees. As the impact of climate change and the dangers of inaction become more clear and younger, more sustainability-aware generations enter the workforce, they build a critical mass of employees advocating not only for internal eco-friendly practices but also for companies to consider the wider societal impact of their business and to act in a positive manner. Employee activism will only increase, and both boards and executive teams have to make sure that they communicate often and clearly on how their company is progressing toward their goals. The relationship with the communities in which companies operate is an equally important aspect that requires the board's attention, as national and local governments ultimately sanction businesses' license to operate.

10 *CEO Pay and the Workforce: How Employee Matters Impact Performance-Related Pay in the FTSE 100*, CIPD and High Pay Centre, December 2020, highpaycentre.org.

11 "2020 ESG survey of board members and senior executives," Willis Towers Watson, December 16, 2020, willistowerswatson.com.

12 *Route to the Top 2020*, Heidrick & Struggles, November 19, 2020, heidrick.com.

13 Laurence Fletcher, "Ethical CSR focus triggers hostile investor activism, study finds," *Financial Times*, August 3, 2020, ft.com.

Having a true believer as chair

The chair needs to be a champion of sustainability, to understand the wider landscape of how ESG trends are evolving in their industry and also have in-depth knowledge of the issues most relevant to their company. The chair will need to foster an inclusive culture in their boardroom, where all directors feel they can express what may be differing views on sustainability, feel that they are heard, and know that they are able to challenge views they disagree with. As chairs set and lead the board agenda, they are in the best position to make sure sustainability is part of each critical conversation the board has with the organizational stakeholders including the annual general meetings with shareholders, potential like-minded investors, community leaders, and employee groups. As some chairs and board members pointed out, the corporate voice needs to be better heard by governments all over the world, and chairs play an instrumental role in making sure that their companies' views are part of that one voice.

There is no doubt that sustainability has gathered significant momentum in Europe's boardrooms. But only a handful of organizations have already cemented their purpose and sustainability-driven business models successfully. The vast majority are still in the process of understanding what their goals are and how their journey to a sustainable business will look. Boards can help their companies blend profit and purpose seamlessly into their strategies and find the best green paths ahead by focusing first on their own purpose, composition, and processes.

Five aspects of board performance on sustainability

Power

- How well does the balance of power in the boardroom reflect the importance of sustainability to the business's strategy, ownership structure, and key stakeholders?
- Does sustainability have the support of key stakeholder groups: the board, employee groups, and investors?
- Are decisions on sustainability made in the boardroom as a group, where everyone can participate in the conversation, or mainly in separate committees?
- How does the personal leadership style of the chair and other board members help drive the sustainability agenda?

Priorities

- Is the board clear on how sustainability influences its purpose? What is the work that only this group of people can do in support of the organization's purpose?
- Is the board clear on the priority sustainability has among its near- and long-term priorities? Is the board clear on how it will work with management to meet those goals?

Perspective

- Does the board have—among its members or advisers—the right mix of diverse perspectives and expertise in sustainability to guide the company in the short and long term?
- Do some board members—for or against sustainability—have an outsize voice in decision making, or is the board inclusive of all views?
- Has the board ensured that the executive team has the right capabilities and behaviors to meet the company's sustainability goals?

People, planet, profit

- Is sustainability embedded in the company's purpose?
- Does the board have clear tools and metrics to understand the company's impact and progress on the sustainability issues that matter most?

Process

- Does the board comply with all expectations of regulators, employees, and other stakeholders?
- Is sustainability embedded in the board's decision-making process?
- How is sustainability acumen factored into board succession, talent management, onboarding, and transition?
- Does the organization have the structure and roles required to create accountability for sustainability? Are ESG goals factored into board and executive compensation?

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