The Corporate Governance Dialogue An initiative of ecoDa

ecoDa's Workshop on *The G dimension of ESG*

SUMMARY REPORT - 23 June 2023

ecoDa organized on June the 23rd a workshop with key stakeholders on the G dimension of ESG. The workshop, moderated by Anne-Hélène Monsellato (Independent Board Member and chair of ecoDa's Working Group on Audit Committees), was an initiative of The CG Dialogue, an internal think tank driven by ecoDa.

The event aimed at exploring interdependencies between the quality of governance and the environmental and social dimensions.

Although the term ESG may be recent, the concepts nor the attention are totally new. For decades, academics and society draw the business world's attention to Corporate Citizenship, CSR, and the Triple P bottom line: PPP (planet, people, profit).

However, it remains unclear how the G dimension should be integrated into ESG.

Positioning the G dimension correctly and avoiding the possible pitfalls of a too-narrow approach:

Some authors recommend eliminating the G from ES(G) assessments and considering it as a totally different dimension (a system of checks and balances driving execution and accountability, versus outcomes). EFRAG integrated the G dimension as part of the cross-cutting standards to align with the modifications made to CSRD but with a larger view of what G means, not purely corporate G (as in G1) but also as part of each of the topical ESRS, even if the final outcome, as a first step, is currently reduced from the initial ambition.

Other experts are in favor of limiting the G dimension to elements that foster the execution of E and S. At the end of the spectrum, rating agencies recommend measuring governance quality and performance in its own right and tend to consider the G dimension as an ESG component with the same weight as the E and S dimensions. The ESG rating score is then considered as a cumulative score and the exposure calculation of total ESG performance is based on different factual indicators aggregated into the three pillars (E, S, and G). The risk with this approach is to validate a unique governance model based on an assessment which is independent of the specific circumstances of a company. These scoring boards are also at odds with the comply or explain approach which was prevalent so far in the field of corporate governance, as noncompliance will translate into bad ratings. Companies are disclosing for the sake of disclosing, and there is an overreliance on boiler plate disclosures.

Although they acknowledge the interconnections between the three dimensions of ESG, the rating agencies tend to rate them separately with governance automatically perceived as material for all companies, contrary to environmental and social considerations. Overall, governance considerations tend to more heavily influence positive impacts, relative to E and S. Nearly all of the entities for which the impact of ESG considerations on credit ratings is positive have good governance strengths – the opposite being true as well. The difficulty that emerges is to properly embrace how governance contributes to a modern version of the corporate purpose (integrating externalities, broadening the corporate goal) and sustainability. It should be clear that only focusing on 'input factors' (conforming

to a common understanding of what good CG looks like, such as the number of independent directors, the respect of gender quota, the type of committees, etc.) will certainly not measure the governance quality, nor the governance effectiveness and impact. At the same time, indicators might not measure nor promote the governance quality and effectiveness in its totality because in each corporate model, sustainability is not only non-financial, but financial as well.

Elevating the role of governance:

The discussion during the workshop then focused on how to elevate the role of governance because it has been made clear that we don't lift the full potential of governance yet. What matters is to move to a qualitative assessment of governance and to avoid focusing too much on metrics or one-size-fits-all considerations. There is a need to capture the essence better than the quantity. The only way to properly assess the governance is to engage into a robust dialogue with the investors. Unfortunately, too many investors don't pay as much attention to the G dimension as they do to the E and S. Active shareholders look at bad governance as a factor for disinvestment but rarely look at good governance as a factor for investment.

Recommendations for better dialogue between boards and shareholders:

The information in corporate reports does not always tell how the board really operates and what is happening behind closed doors. Proxy advisors are very much aware that there is a gap between disclosures and actual practices, and that disclosures alone are not enough. This is why their attention is increasingly focusing on business practices as a proxy for good governance. To help them understand those practices, companies must be transparent and honest, and review the content of their disclosures and annual reports through the lens and mindset of the proxy adviser (what information will they get from it).

The number of disclosures continues to increase, but only the dialogue with investors can catch nuances and covey authenticity. The quality of the disclosure is easy to assess but will not provide the same level of information as direct engagement. This dialogue is critical to building trust, explaining things that might be difficult to write and in providing the context. Through interactions with investors, companies have the opportunity to showcase their uniqueness. Public disclosure (specific, not boilerplate) should be considered as a first step and be leveraged beyond minimum requirements: why decisions are made and how do they contribute to long-term success, why is this person considered as a financial expert and what/how does he/she contribute to the board. This is what determines ESG ratings and what will then determine investments. Going beyond what is required by law will create a competitive advantage.

It is important to establish this transparent relationship with investors as soon as possible and on the long run, when a company does not need anything, using contextualization. Governance structures can look good on paper but work out very differently. For example, why the governance structures have been established as such, why they are relevant in the current context of the company, how they will ensure a sound transition phase, and how they provide robust oversight over whether the company is on track.

This being said, governance must be agile and constantly adapt to take into account developments (social listening capabilities, for instance) and society's expectations. That is why considering trends is so relevant. If a company has not reached a target but is continuously improving on one matter, this should be communicated to the investors as it is a positive signal. In the same way, the governance structure of an organization can be of good or bad quality on paper, but the decisive factor is who is

entrusted to uphold the structure. Does the board function as a high performing team with senior management?

Moreover, only dialogue makes it possible to understand how a company reacts to the feedback of investors, especially in case of scandals to mitigate the issues. It is all about the concept of accountability and responsiveness. The dialogue must take place in two ways. Investors are there to ask questions. An open and constructive dialogue means not hiding behind the notion of confidentiality and multiples channels should be leveraged.

In search of a mixed solution:

To conclude, participants agreed that improving governance does certainly not happen overnight. To avoid governance washing, ESG should not be considered in all its components as a reporting exercise only, or a collection of data points. Attention has to be paid to the narrative and to the explanations, especially to get a full understanding of what is happening on the ground. Considering the different components of ESG separately might bring inconsistent policies. Embedding ESG KPIs in governance remuneration and ensuring robust external board evaluations (as opposed to a collection of compliant metrics) remain key factors of good governance.

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