Reimagining Company-Investor Engagement to Catalyze Climate Action

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CST | COUNCIL ON SUSTAINABILITY TRANSFORMATION
CONVENED BY ERM

With climate impacts increasing in frequency and severity, accelerating climate action is urgent for society and imperative for business.

The shift to a net-zero economy aligned with the Paris Agreement and planetary boundaries is creating huge market risk and opportunity. Managing the transition successfully will require foresight and the courage to take decisive action on the part of business leaders. While headwinds are slowing momentum precisely when risk and opportunity are increasing and demanding urgent responses, progress can and must be made in every sector.

This paper advocates for new approaches to company-investor engagement as a way to unlock climate solutions. Three key views underpin the arguments made:

1. **Corporate climate action is at critical juncture. While companies have increased understanding of climate-related impacts and set ambitious decarbonization targets, they are finding it difficult to deliver against their goals.**

2. **Lack of institutional investor support is one of the biggest roadblocks to rapid decarbonization. Some of this lack of support is rooted in misaligned timelines and incentives, and some in different levels of understanding of the market risks posed by climate change.**

3. **We must redesign company-investor engagement to close perception and operational gaps and maximize the private sector contribution to addressing the climate crisis.**

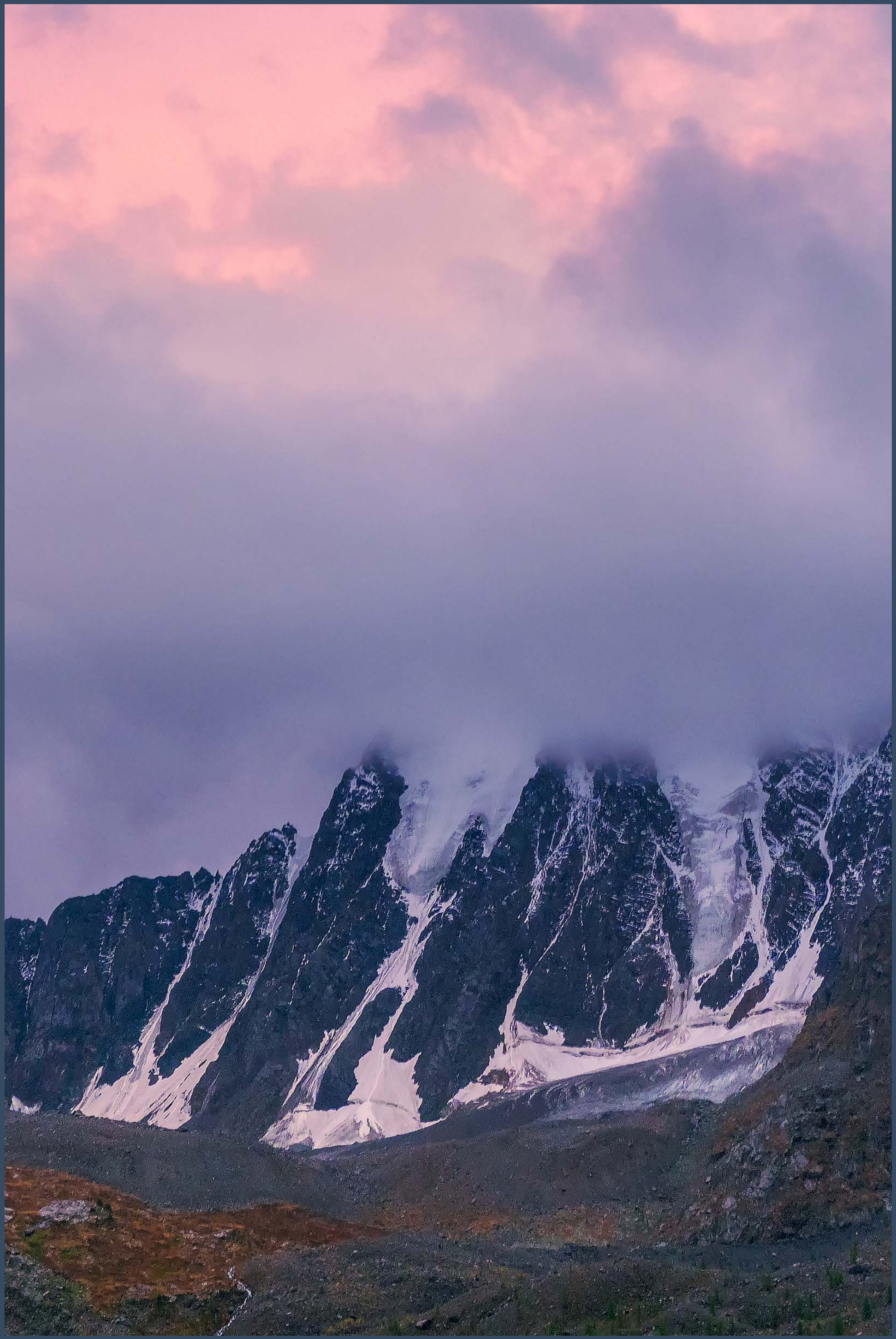
For all these reasons and more, to navigate climate-related challenges and accelerate decarbonization, business leaders need to strengthen investor engagement. They will also require deeper collaborations with other actors, particularly government, as both companies and investors will require policymakers to put in place frameworks that encourage and reward faster climate action.

1.

Corporate climate action is at a critical juncture.

While significant barriers exist, companies can develop climate strategies that align with their business objectives and allow progress.

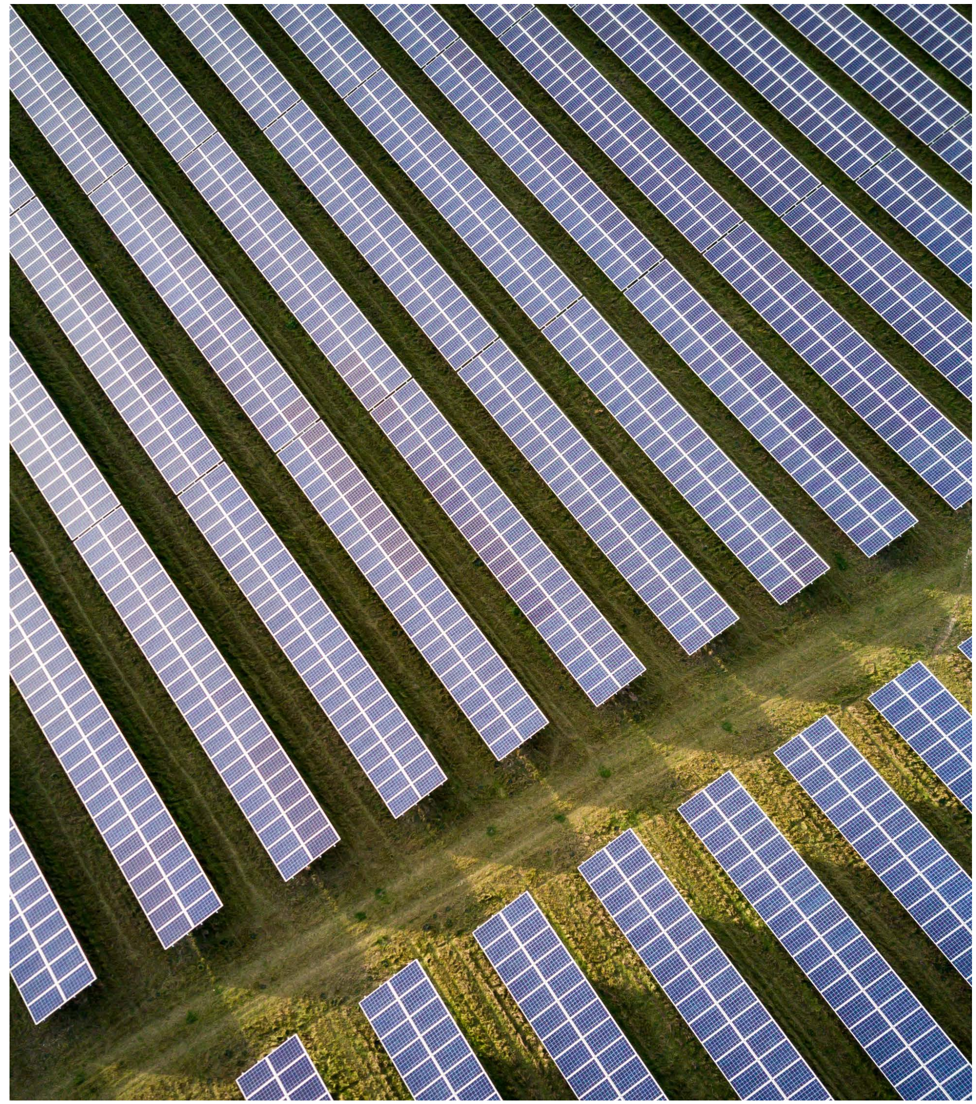
There are many signs of positive movement. The rapid growth of clean energy investment is a good example. In some parts of the economy, like EV adoption, progress has vastly outpaced projections, while investments in energy efficiency deliver direct benefits to businesses of all kinds. Leading companies have made significant climate-related innovation investments in recent years which they are determined to see through, and no business wants to miss the market openings that decarbonization will generate.



At the same time, some corporate efforts are slowing, buffeted by a combination of headwinds including:

- Pushback on both sides of the political spectrum over the perceived costs of climate action and value of ESG
- Minimal or delayed returns on some investments
- Geopolitical divides, conflicts, and instability
- Weakening international collaboration
- Uncertainty on future national climate policies given the changes of government elections may bring
- Economic challenges and competitive pressures
- Constrained corporate resources from budgets to competency gaps, and
- Lack of investor support.

Lack of corporate understanding plays a part here too. Despite the extensive scientific evidence showing climate change is real and that its impacts are mounting, many private sector actors do not yet grasp how significantly it will affect the markets they participate in and their organizations. Many others are waiting for stronger signals before putting climate strategies in place, which may only increase their future vulnerability by limiting the time they will have to respond when they do act.



No time to be passive.

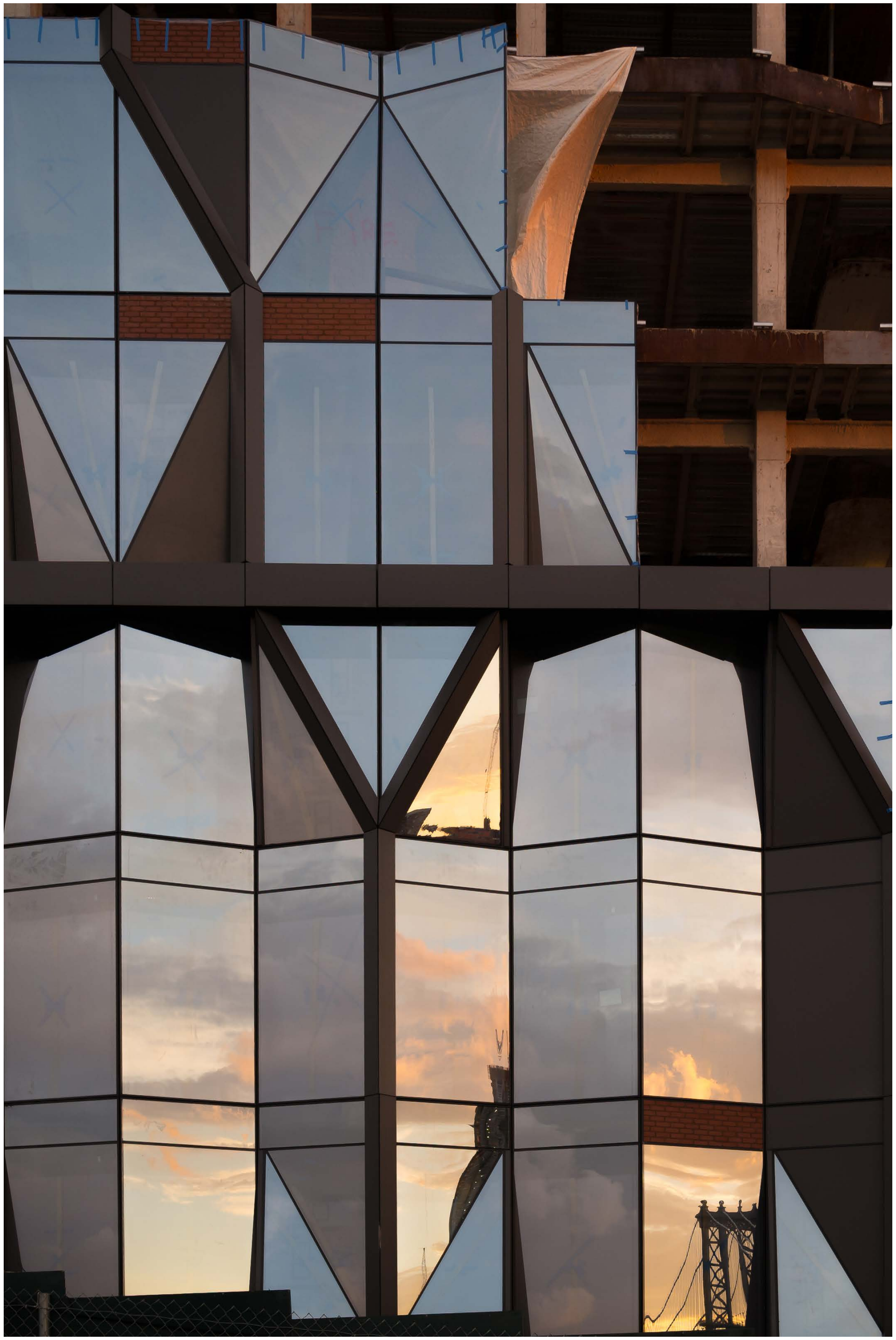
When policy guidance is lacking or unclear and debates are polarized, companies may adopt a wait-and-see approach. This tactic is unwise.

Policy uncertainty and polarization do not slow climate impacts already affecting business operations. These include physical supply chain risks like the impacts of extreme weather and flooding, increased transportation costs and higher costs of goods, resource scarcity and resource access issues, and the threat of losing insurance coverage when regulation or market preferences change. At the same time, corporate adaptation investments like reducing water use are increasingly attractive given the returns they provide in terms of monetary savings and increased resilience, demonstrating how climate action can be good for business as well as society and the planet.

We must remember also that business inaction impacts political courage, risking a vicious cycle where corporate and policymaker hesitation feed on one another. Such a situation is untenable when both increased private sector leadership and more robust government frameworks are needed to stem and reverse climate change and its impacts.

Some businesses have complained about the recent wave of sustainability-related disclosure regulation, and CEOs rarely seek more prescriptive rules. But more and better government climate policy will be essential, meaning corporate leaders should proactively engage policymakers to shape approaches that address climate change without stifling the economy.

Overall, pushing against the tide, doing nothing, or simply not moving quickly enough, only delays the implementation of needed solutions.



2.

Lack of institutional investor support for climate action is one of the biggest roadblocks to rapid decarbonization.

Harmonizing corporate-investor interest.

Senior corporate leaders clearly need to create and implement plans that prepare their organizations for the future net-zero economy.

To successfully implement difficult and complex decarbonization plans, companies need investors to understand and support the ways climate strategies help mitigate risk and maximize resilience. In theory, investors should recognise the benefits of such forward-thinking approaches, which should allow them to de-risk their own portfolios and benefit from investments in low-carbon transition leaders.

The reality of corporate-investor engagement on climate, however, is often very different from this theory, creating a major roadblock to progress that must be overcome.

Decarbonization is difficult and company-investor engagement is often too shallow.

Today's engagement approaches often frustrate businesses and investors by being too shallow or inconsistent. For example, equity markets have recently pulled back from several major firms with high profile climate transition plans, while seeming to reward others for lowering their ambitions.

This says as much about corporate decarbonization proposals as investor views on climate. Companies cannot expect support for decarbonization pathways misaligned with investors' fiduciary duty to maximize returns. Achieving environmental and social goals cannot come at the expense of profitability or vice versa; success means optimizing financial returns and meeting sustainability goals together.

Climate action is mostly voluntary, and data quality is poor, making it hard to measure and reward performance.

From an investor perspective, the landscape of climate action – voluntary in all but a few jurisdictions and cluttered with different guidelines, standards, and ratings – is both inadequate and difficult to navigate.

Meanwhile, measuring corporate performance on decarbonization remains a work in progress. Efforts to consolidate sustainability reporting expectations are making the information demanded of companies by investors more coherent, but approaches are far from consistent, which impacts data quality.

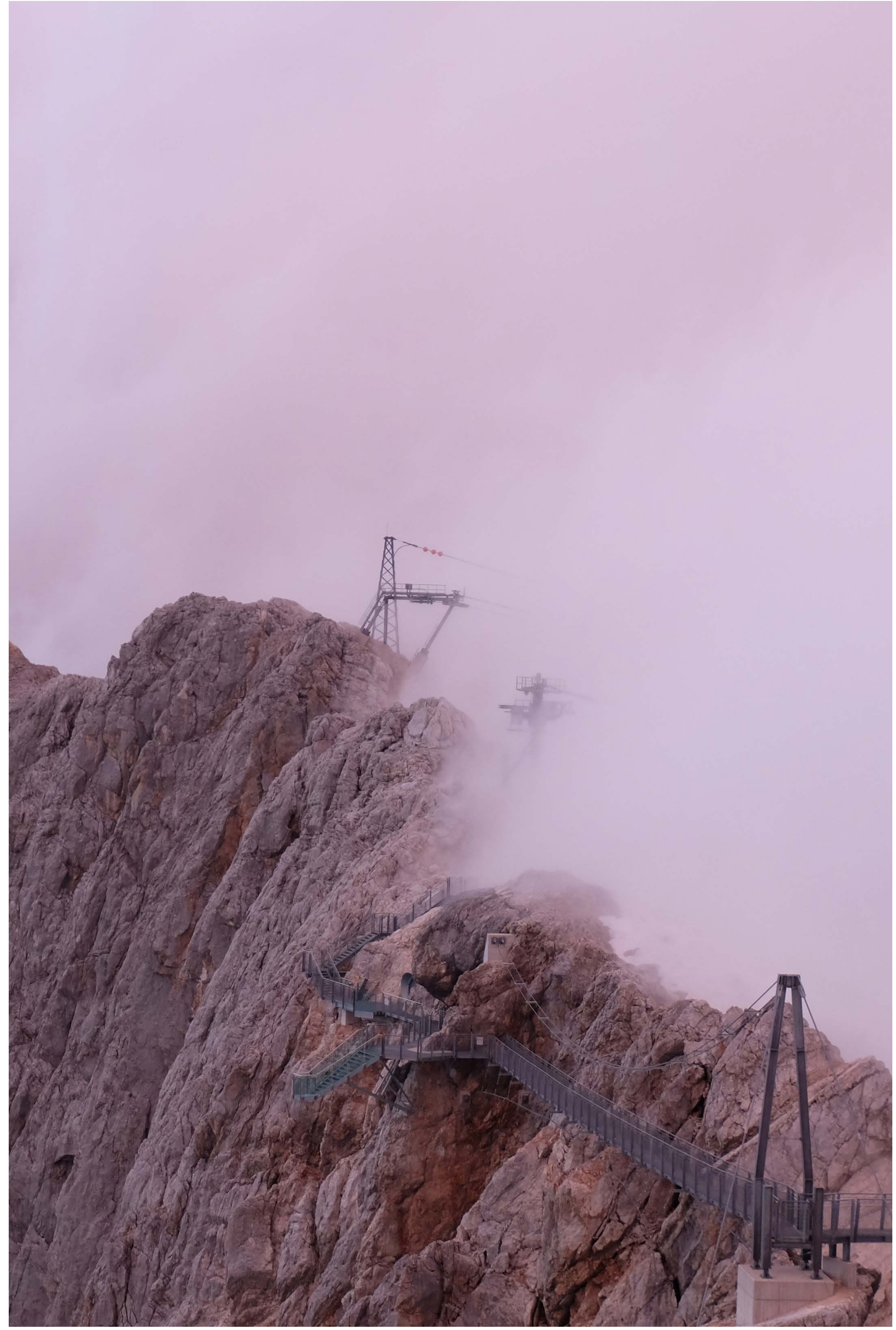
Lack of consensus on evaluating transition plans in and across sectors.

Overall, there is little consensus on how to evaluate the robustness of individual corporate climate transition plans or how to meaningfully compare them to one another in and across sectors. Additionally, investors themselves now must respond to regulations and standards like the EU's Corporate Sustainability Reporting Directive (CSRD) and the IFRS's International Sustainability Standards Board (ISSB) that demand greater disclosure. Investors also have to navigate issues that will impact investments like carbon markets and carbon pricing.

All these circumstances heighten complexity, and they are unlikely to be resolved quickly or simply while relying mostly on voluntary action. As climate impacts become more severe, there will be more pressure to clarify and formalize this landscape so that investors can journey across it more smoothly.

We need a new way.

Identifying how companies and investors can engage and collaborate more effectively may offer the best hope of unlocking swifter climate progress. All parties need to have the long-term perspective that future-proofing business with climate action will pay off over time. Companies and investors also need to invest in climate-related competence and capacity, including at board level.



3.

Redesigning company-investor engagement to address climate change.

Building a foundation for dialogue that delivers decarbonization and returns.

Given the critical importance of rethinking investor engagement as a catalyst for climate action, the rest of this paper suggests actions business leaders can take to achieve this at the same time as deepening their own climate actions and working to improve system conditions, including government policy, under which they operate.

3a | Integrate climate efforts fully into business strategy.

Companies that successfully manage the transition to the net-zero economy will be profitable and sustainable. This requires climate initiatives and corporate sustainability plans to be fully integrated into overall business strategy. It is more important for plans to be effective than perfect – each sector and company will face different challenges and need flexibility to determine the best ways to tackle them, as the speed and difficulty of change will vary by industry. What is right for individual companies will depend on where each operates too, as appropriate starting points and emphasis also vary by geography.

The challenge for corporate leaders is to develop and communicate decarbonization propositions that are acceptable to investors even if they reduce short-term returns because of the risk mitigation and value creation the transition strategies can deliver over time. While this will be more difficult, for example, in the steel industry than the power sector, the key for business leaders is creating credible and compelling plans specific to their organization.

Companies must identify the ways climate affects profitability and embrace approaches to address them including energy efficiency measures and other actions available to most companies where the scale of impact is often underestimated.

Winning corporate climate transition strategies are relevant and operationalized in every part of a company. Sustainability and climate have far-reaching financial and reputational impacts on private sector organizations. Business leaders must approach sustainability and climate issues in ways that allow them to meet shareholder and stakeholder expectations without unreasonable short-term consequences.

3b | Develop a convincing and compelling narrative.

Ensuring long-term profitability in the decarbonized economy of the future will sometimes require significant short-term investments. This must be central to company-investor communication and mutually understood and accepted.

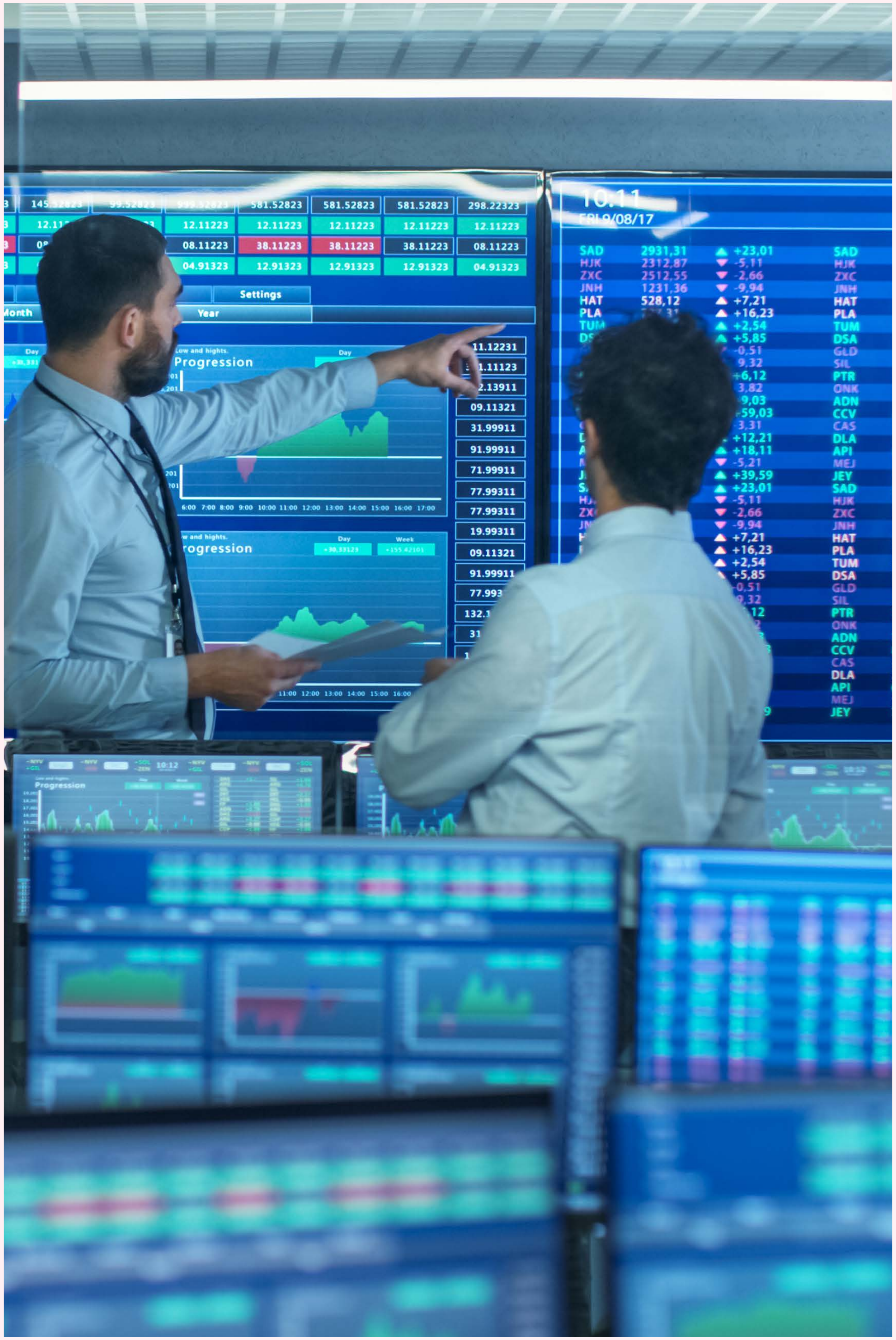
Investors need to be persuaded that climate strategies drive innovation investments which create value and enable climate action over time. Cost efficiencies and new revenue streams can be derived from well-executed innovation plans. Business leaders must ensure investors understand and support how climate strategies will affect performance at different stages of implementation. This requires educating investors on the ways climate change is shifting markets, which is critical to investors becoming confident enough to take smart investment risks that favor quicker improvements in climate-related action and contribute to overall business performance and returns.

Senior business leaders, particularly the CEO, are accountable for climate strategy and communication. Standard sustainability reporting and disclosure will not accomplish this – addressing climate disclosure regulations and responding to key ratings is necessary but not sufficient for communicating the scope and complexity of the kinds of climate transition plans needed as well as progress against them. Robust ESG-related reporting and disclosure is important and must be undertaken seriously, but reporting on every issue can result in too much resource allocation on disclosure and too little investment in actual climate action. Companies need to comply with disclosure requirements but steer the maximum possible resources to the most material issues and actions rather than ever-broader reporting.

3c | Influence shareholder composition.

Business leaders seeking to implement a proactive decarbonization strategy cannot be passive about their share register. While no publicly traded business controls who holds their shares, companies can influence shareholder composition. There needs to be a concerted effort to identify and appeal to investors interested in supporting sustainability-related transformations. Companies may also need to consider other actions, including restructuring business models, to attract the sort of investors desired.

While this paper focuses on publicly traded companies and their shareholders, it is relevant to private markets. Such markets are growing in terms of capital and influence, and we anticipate a future where a greater proportion of capital and a growing number of forward-looking investors are private. Private equity (PE) investors need to be sold on the strength of corporate climate strategies and performance, which increasingly impact valuations and thus PE investment decisions.



3d | Expect resistance and hold the line.

Most companies still will end up with some investors who doubt decarbonization's value. Here corporate leadership needs a carefully balanced program and narrative that pushes decarbonization forward while adjusting the pace of transformation when required to keep different investors onside.

Business leaders should respond clearly and consistently to investor questions on climate, explaining how climate investments will mitigate risk short term and maximize resilience and profitability long term. Often that will be enough for the business and its shareholders to move forward together. When investors hesitate or resist, business leaders need to be patient but firm, remaining consistent with plans and actions while adapting communication as required to reach different investors and, when necessary, holding steadfast or even pushing back on investors' views until sufficient alignment can be reached to proceed.

Some investors may push for cost reductions or dividends that undermine a company's ability to invest in climate-related transformations designed to create greater value over time. Others may be influenced by politicized external pressures which undermine climate science and the rationale behind decarbonization activities. Some financial institutions may communicate conflicting messages, with fund managers urging companies in one direction and ESG specialists in another. Additionally, many investors lack internal skills and knowledge relevant to their evaluation of corporate ESG and climate performance, often relying on proxy advisory firms to decide how to vote on shareholder resolutions, which may limit the quality of direct engagement possible.

Other issues may have unintended consequences. When leading investors divest from hard-to-abate sectors, less responsible investors often step in, reducing the pressure on these sectors to decarbonize. Similarly, the growth of climate-related litigation requires careful and nuanced thought. While legal recourse is legitimate and essential to well-functioning societies and economies, some companies now hesitate to commit to ambitious decarbonization programs for fear of being taken to court if they fail to deliver them in full.

In such circumstances, forward-thinking business leaders and investors will need to speak out and take actions that help ensure that incentives for positive corporate action are not undermined.

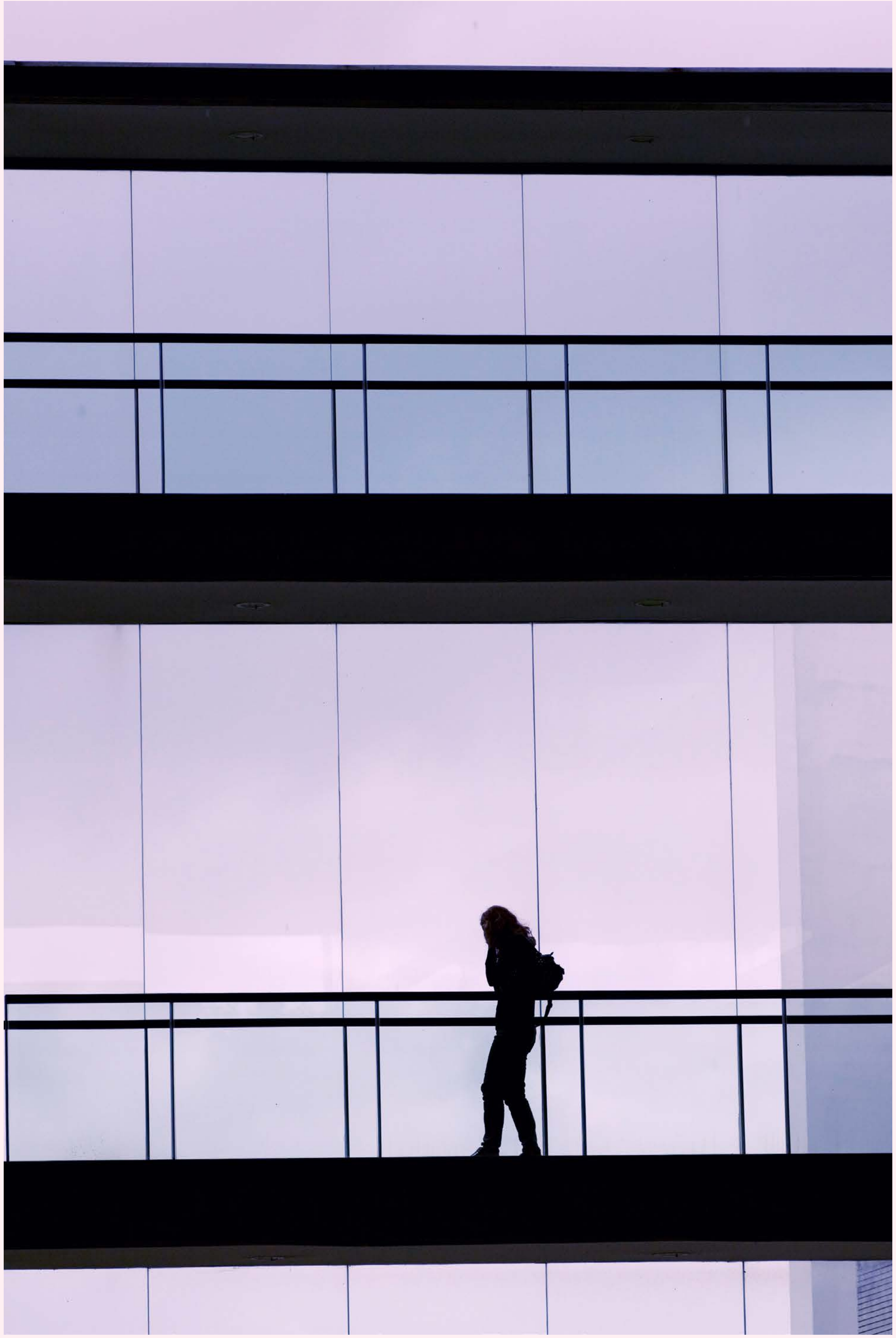
3e | Lead system change and ambitious collaboration.

While climate action linked to value creation and investor engagement is essential to addressing climate impacts, companies are limited in what they can do by the nature of the systems in which they operate. That said, systems are dynamic, and companies can and should use their power and influence to help them evolve in ways that support climate action. Companies can involve investors in these efforts also.

Business leaders need to advocate for the kinds of systems change required to accelerate decarbonization of the economy and reward companies that take climate leadership. Such changes will help private sector entities future proof their organizations. Further examples of the potential positive effects of such advocacy include:

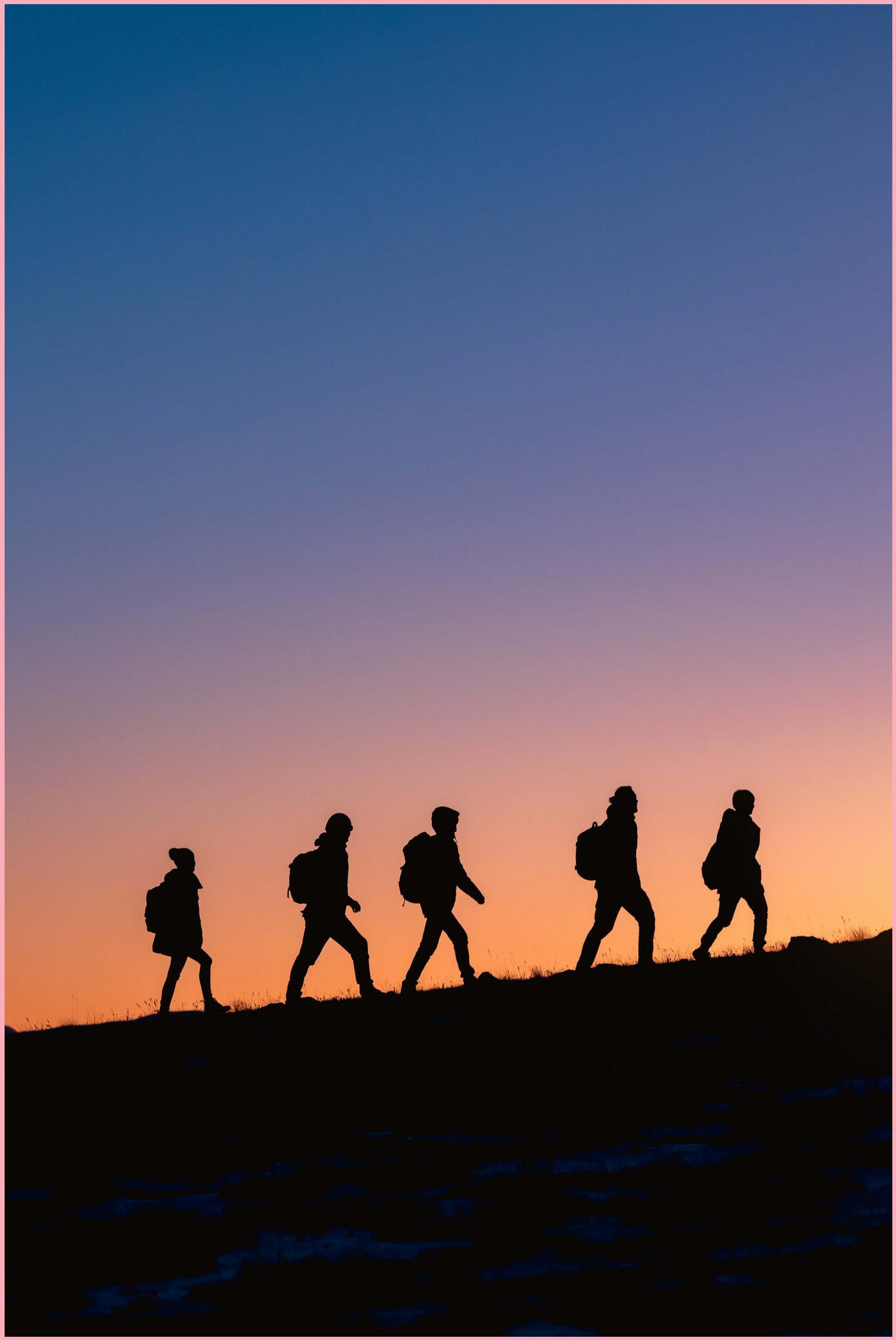
- Financial markets reform
- Regulatory action and harmonization
- Finding ways for investors to adopt longer-term perspectives, and consider new financing models
- Standardizing sustainability reporting methodologies used to evaluate companies' climate transition plans in ways sufficiently uniform to allow comparison, yet flexible enough to accommodate different regional operating contexts, and
- Development of sectoral transition plans suited to the unique circumstances of different industries.

In all these areas, companies are likely to make more and faster progress by working in collaboration with policymakers and other businesses. Making this collaboration open and transparent will reduce skepticism by allowing stakeholders to judge whether the efforts have more sustainable societal outcomes rather than corporate self-interest at heart.



Conclusion.

Corporate climate action will make the most difference with the support of investors and in partnership with policymakers and value chain partners. While not yet moving at the pace required, acceleration is in reach. Catalyzing decarbonization will benefit business, investors, and society by enabling the transformation of the economy required to stem negative climate impacts and unlock new market opportunities aligned with the transition.



About the Council on Sustainability Transformation.

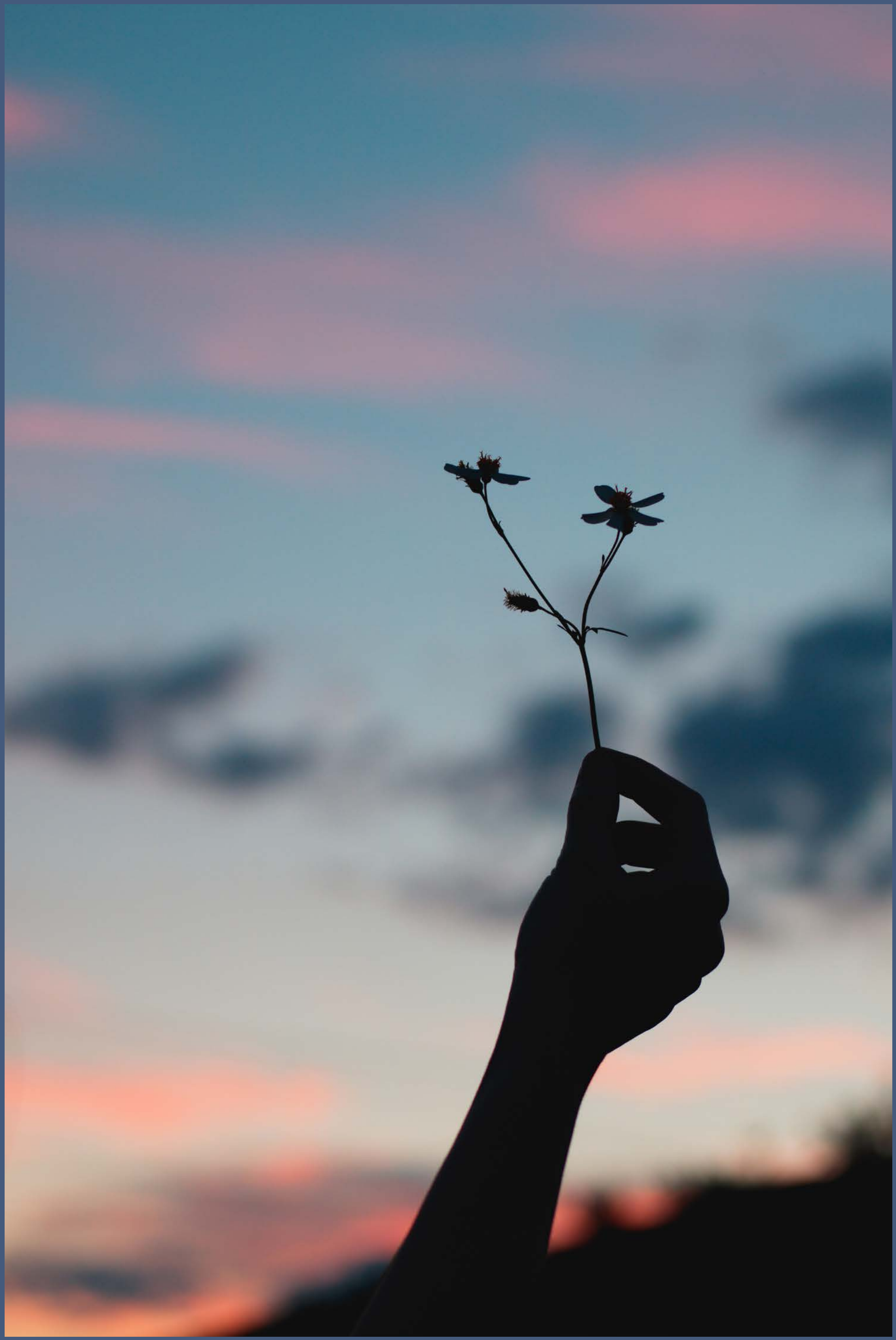
Thousands of major companies have committed to climate action and other sustainability initiatives. While the commitments are real, many organizations find it difficult to achieve the transformational change required to reach their ambitions.

Convened by ERM, the Council on Sustainability Transformation (the Council) is a group of highly experienced and well-respected leaders from corporations, governments, and academia focused on accelerating private sector action on critical sustainability challenges.

The Council looks at obstacles to progress, marshalling the experience of its members and other experts to develop recommendations on how to overcome them and future proof businesses.

The Council will issue a series of papers that explore topics relevant to accelerated corporate action on sustainability. The first focuses on how companies can ensure greater investor support for climate action.

The Council's main target audiences are C-suite executives and board members of major global corporations plus important corporate stakeholders such as customers, employees, investors, policymakers, regulators, and civil society including NGOs.



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