Vanguard Investment Stewardship Insights

Climate risk governance: What Vanguard expects of companies and their boards

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Vanguard publishes Investment Stewardship Insights to promote good corporate governance practices and to provide public companies with our perspectives on important governance topics and key votes. This is part of our growing effort to enhance disclosure of Vanguard's investment stewardship voting and engagement activities. We aim to provide additional clarity on Vanguard's stance on governance matters beyond what a policy document or a single vote can do.

Vanguard is passionate about our clients' financial success over the long term. Our more than 30 million clients worldwide trust us to protect their investments as they spend decades saving for important goals. We work hard to safeguard their assets against a full range of short- and long-term risks. Climate change represents a profound, fundamental risk to investors' long-term success, and we approach climate risk from a fiduciary perspective.

Over the past several years, Vanguard has invested greater time and resources in monitoring climate-related risks in our funds' portfolio companies. Today, our Investment Stewardship program addresses climate risk through top-down and bottom-up analysis.

One way our analysis is reflected is through the proxy votes cast by each Vanguard fund. The votes are an important opportunity for the funds to protect long-term shareholder value. We carefully analyze every climate-related proposal. At companies where climate matters present material risks, the funds are likely to support shareholder proposals that seek reasonable and effective disclosure of greenhouse gas emissions or other climate-related metrics. The funds may also support proposals that ask companies to pursue climate risk mitigation targets, such as those aligned to the goals of the Paris Agreement.

The funds are unlikely to support proposals requiring companies to make specific operational changes, such as phasing out a business or product; we generally view such proposals as overly prescriptive.

Vanguard has had a wider and deeper impact on climate-related matters through our direct engagements with portfolio companies. Last year, we spoke with more than 250 companies in carbon-intensive industries. We also regularly talk about climate risk with companies beyond those in the top carbon-producing and carbon-consuming sectors. Few companies will be entirely insulated from the impacts of climate change.

What Vanguard expects of companies and their boards

It is critical that public company boards fully understand and own climate-related risks. Why? Because the actions—or inaction—of individual companies on this global issue can affect the long-term health of companies and the investable markets.

We expect boards to effectively oversee climate risks and become more transparent about their decision-making process. Vanguard does not seek to dictate strategy; rather, we expect companies to be fully aware of climate risks and opportunities as part of a foundation for making the most sustainable long-term decisions.

Company boards should consider the implications beyond ***physical risks,*** such as devastating weather events, rising sea levels, and temperature changes. Boards will need to consider ***transition risks*** as well—such as regulatory changes and technological disruption—and plan for significant shifts in consumer behavior.

Looking ahead, the boards that will be most effective in protecting long-term investors from climate-related risks will be (1) purposefully composed to be competent on climate matters, (2) vigilant in their oversight and mitigation of climate risk, and (3) clear and effective in disclosing climate-related risks.

Climate competence

Where climate issues are material to a company, we expect that the company has established a ***climate-competent*** board that can foster healthy debate on climate topics, challenge management assumptions, and make thoughtful and informed decisions regarding these risks.[1] Effective climate-competent boards will seek multiple perspectives from internal and external stakeholders to inform their perspective on climate issues. Boards can deepen their knowledge of climate issues in several ways:

Appoint directors with relevant experience. Some directors may bring direct experience with climate change or business adaptation. Relevant experience, however, does not necessarily mean deep climate-science expertise. Some directors bring distinct qualifications that are highly relevant to climate risk but derived from unexpected sources: change-management skills, expertise turning around a business on a downward trajectory, or a background in pivoting a business model to take advantage of new technology or thrive in a changing regulatory environment.

Seek diverse perspectives. Collectively, the board should have a range of perspectives on climate issues. For example, a director with a European background may have a different sense of the global regulatory and consumer landscape than a North American director. The perspectives of a director with consumer goods experience will differ from those of one with an electric utilities background. Engaged discussion among directors with a variety of backgrounds may lead to detecting risks and uncovering opportunities that a more homogeneous group could miss.

Participate in ongoing education. Boards should proactively build their knowledge base and stay current on the interplay of their industry and the changing climate. This should include regular engagement with external experts and stakeholders, in the boardroom, and through governance or industry groups.

Typical questions for boards

Direct engagement with companies enables Vanguard to hear from company executives and directors and to share our perspectives on behalf of the Vanguard funds. The following are the types of climate-related questions we might ask during an engagement:

- What are the top climate-related risks for the company? How does the board determine the materiality of risks?
- How are the company's key financial metrics affected by climate risks?
- How are these risks reflected in long-term strategic and financial planning?
- How does the board set goals and measure performance on the company's management of climate-related risks?
- Which board committee has primary responsibility for overseeing the company's climate strategy and risk management?
- Does the board hear from outside experts, including those whose views may diverge from management's?
- How have industry standards or peer disclosures informed the company's choices on climate risk identification, monitoring, goal-setting, and reporting?
- How does the company think about the objectives set forth by the Paris Agreement?
- How do the board and management incorporate potential climate scenarios or sensitivity analysis into long-term strategic decisions? Does the company build internal scenarios or use established scenarios such as the International Energy Agency's?
- How does the company's regulatory and policy engagement support its climate change strategy?

1 Ceres, a sustainability nonprofit organization, popularized the term *climate competence.* See www.ceres.org/news-center/blog/why-you-should-care-about-climate-competent-boards.

Risk oversight and mitigation

While diversity of thought will lend greater insight and a range of perspectives, we also want to understand the board's process for overseeing and mitigating climate risk. A highly engaged board will ensure that climate-related risks and opportunities influence short- and long-term planning. Best practices include:

Set goals and targets. The board should set or approve clear and meaningful climate-related goals related to the company's comprehensive strategic and financial planning. The goals set forth in the Paris Agreement have become a widely accepted standard for countries and companies aiming to address climate change. Where climate change is a material risk, Vanguard encourages companies to set targets that align with these goals and to disclose them clearly.

Assess progress. Boards should be aware of their companies' performance on material sustainability issues, both on an absolute basis and relative to peers.

Assign responsibilities. Accountability for closely overseeing and making recommendations about climate-related issues should be clearly articulated. Where climate risks are material, they should be assigned to a specific committee, which should share key matters with the full board.

Integrate into planning. The regular review and analysis process should inform the company's strategic planning and capital allocation decisions.

Seek the best information. Boards should get information from diverse sources, both internal and external. Directors should have unfiltered access to internal specialists and the authority to invite relevant external subject matter experts.

Harness analytics. Analytical tools such as scenario or sensitivity analysis support rigor and mitigate bias in an oversight process.

Effective disclosure

Vanguard expects companies to disclose to the market how their board oversees climate-related strategy and risk management. We look for companies to provide quantitative disclosure of their performance metrics and progress against goals. We also seek qualitative disclosures of governance, strategy analysis, and risk management processes. Our interest is in transparency that enables meaningful analysis, productive dialogue, and accurate security pricing.

We view sustainability disclosures through the lens of materiality, and we focus on the risks most relevant to a particular industry and business model. Although we do not penalize companies for acknowledging risks without concurrently delivering a perfect mitigation strategy, we expect to see progress toward solutions and look for companies to improve disclosure and strategies over time.

A number of widely recognized industry frameworks provide useful guidelines for companies that seek to improve their sustainability disclosure. We support the framework created by the Task Force on Climate-related Financial Disclosures for disclosing strategy, risk management, governance, metrics, and targets. We expect the TCFD to continue to gain acceptance as a global standard (see the table on the next page).

The Sustainability Accounting Standards Board produces useful industry-specific, materiality-oriented sustainability disclosure standards. We also support industry efforts with broad adoption, such as the Edison Electric Institute's sustainability reporting template for U.S. electric utilities.

We have been encouraged by signs of convergence among major reporting frameworks and standard-setters on climate change; this would reduce the reporting burden for companies and eliminate confusion for market participants.

Key considerations for disclosure:

- Disclosures should reflect past performance *and* forward-looking analysis so investors can determine the resilience of a company's long-term strategy.
- Structured analysis such as scenario or sensitivity analysis can help companies think concretely about their strengths and vulnerabilities.
- Metrics should reflect changes over time or be intensity-based to tell a complete story.
- Short- and long-term target-setting with year-over-year reporting enables investors to appreciate how a company measures its own progress.

The TCFD's 11 recommended disclosures

The TCFD has made recommendations that it believes will help investors understand how companies assess climate-related risks and opportunities.

Governance	Strategy	Risk management	Metrics and targets
Disclose the organization's governance around climate-related risks and opportunities. 1 Describe the board's oversight of climate-related risks and opportunities. 2 Describe management's role in assessing and managing climate-related risks and opportunities.	Disclose the actual and potential impacts of climate-related risks and opportunities on the organization's businesses, strategy, and financial planning where such information is material. 3 Describe the climate-related risks and opportunities the organization has identified over the short, medium, and long term. 4 Describe the impact of climate-related risks and opportunities on the organization's businesses, strategy, and financial planning. 5 Describe the resilience of the organization's strategy, taking into consideration different climate-related scenarios, including a 2°C or lower scenario.	Disclose how the organization identifies, assesses, and manages climate-related risks. 6 Describe the organization's processes for identifying and assessing climate-related risks. 7 Describe the organization's processes for managing climate-related risks. 8 Describe how processes for identifying, assessing, and managing climate-related risks are integrated into the organization's overall risk management.	Disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities where such information is material. 9 Disclose the metrics used by the organization to assess climate-related risks and opportunities in line with its strategy and risk management process. 10 Disclose Scope 1, Scope 2, and, if appropriate, Scope 3 greenhouse gas (GHG) emissions, and the related risks. 11 Describe the targets used by the organization to manage climate-related risks and opportunities and performance against targets.

Source: Task Force on Climate-related Financial Disclosures, 2019. *2019 Status Report,* page 2, Figure 2; available at www.fsb-tcfd.org/wp-content/uploads/2019/06/2019-TCFD-Status-Report-FINAL-053119.pdf.

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