ESG – A chance for change

In years to come, we may look back on 2020 as a milestone on the corporate sustainability journey. The COVID-19 pandemic was, for many people, eye-opening in demonstrating how economic progress, health and social welfare as well as environmental aspects are interlinked. But even more than this, 2020 might be remembered as the awakening of business to other pressing societal challenges, in particular climate change. The race towards "net zero" has accelerated and prominent companies have joined a growing pack of business leaders pledging to decarbonize their operations and supply chains.

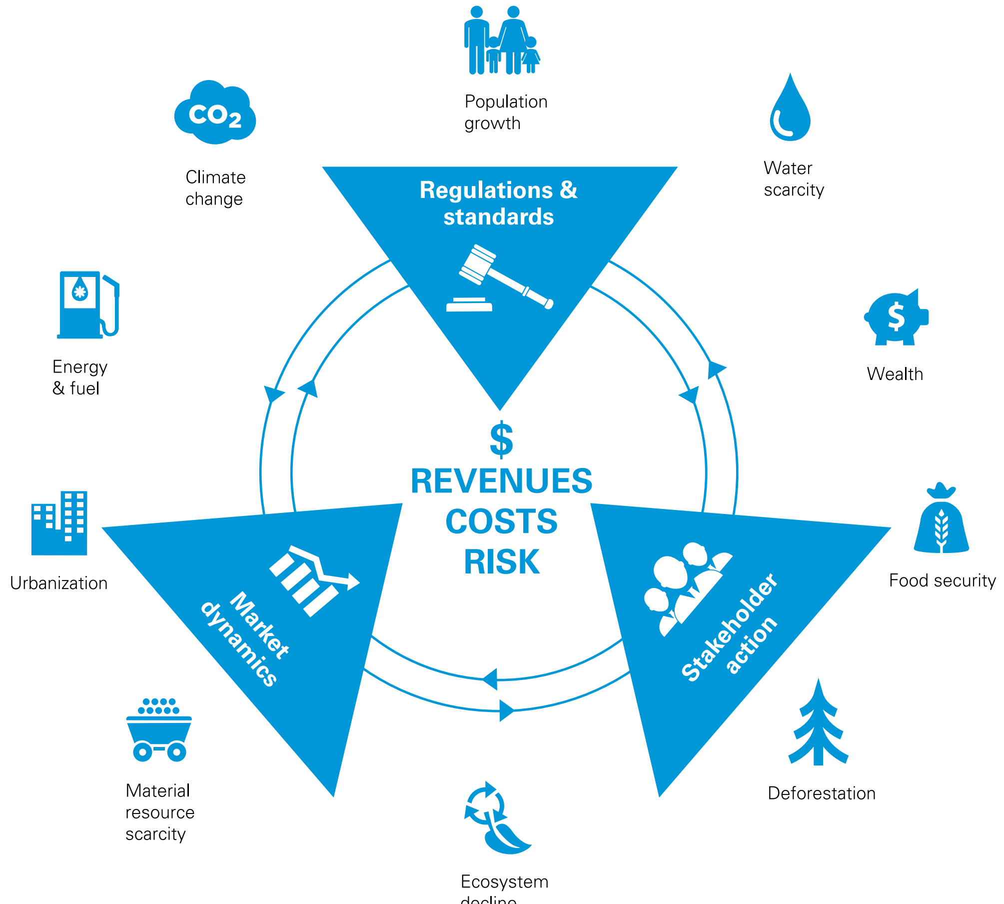
Time to take ESG (Environmental, Social and Governance) seriously

Climate change has clearly become a top-priority, not only for the broader public, but also for investors. KPMG's latest survey of sustainability reporting 2020 reveals that amongst the top 100 companies in all countries in scope, 65% report on their carbon reduction targets. In Switzerland, approximately half of the largest 100 companies have already published carbon reduction targets as of 2020. This marks a tremendous increase within the last three years and underlines that now it is the time for action – and management attention.

The year 2020 might turn out to be unforgettable for Swiss business leaders for another reason: the shift away from a voluntary and self-responsible approach to environmental, social and governance (ESG) matters and towards additional hard law. Either the Swiss people will vote to adopt the responsible business initiative (RBI) on 29 November 2020, or Parliament's counter proposition will be enshrined in Swiss law after that date. Both options provide for additional transparency requirements and an expansion of the legal boundaries of corporate responsibility. Both will add complexity to business reporting and risk management procedures. ESG definitely left its infancy in 2020 and now needs to be taken seriously by business and the Audit Committee in particular, as transparency and compliance on ESG topics will be crucial.

ESG translates into financial success

Managing ESG aspects is not just a compliance exercise. The business community is increasingly realizing that – despite the positive impact of business in, for example, reducing extreme poverty or creating jobs through economic growth – such success comes at a price. In the course of doing business, companies draw on the planet's natural resources and affect people and the environment. Dependencies on such resources and increasingly a changing business environment create risks and opportunities for companies that are more and more likely to hit a company's P&L. Previously externalized impacts, i.e. impacts for which society as a whole bore the costs, are rapidly being internalized, whether through new regulations, changing market dynamics or more frequent and impactful stakeholder pressure.



Source: KPMG (2014). A New Vision of Value: Connecting corporate and societal value creation

The most direct bottom-line impacts usually come from regulation. Climate legislation, for example, has risen sharply in recent years. Assuming that politicians are serious about their commitment to the Paris Agreement and trying to limit global warming to well below 2°C, more regulation is likely. In 2010, only about 5% of the world's carbon emission were covered by a carbon price. Today the proportion stands at about 15%, with China potentially set to roll out one of the biggest schemes in the world soon and many other countries likely to follow. Carbon prices are also on the rise. Some even believe that price hikes could reach a level that would wipe out a significant share of global market capitalization and impact many companies' bottom line in the future. But not only so-called transition risks are to be considered. Physical risks from climate change are already materializing today, forcing companies to think about their supply chain and its resilience.

Natural catastrophe losses intensified by climate change (2017–2019)[1]

USD$ **640bn**

Value at risk to manageable assets from climate change calculated in present value terms by 2100[2]

up to USD$ **4.2trn**

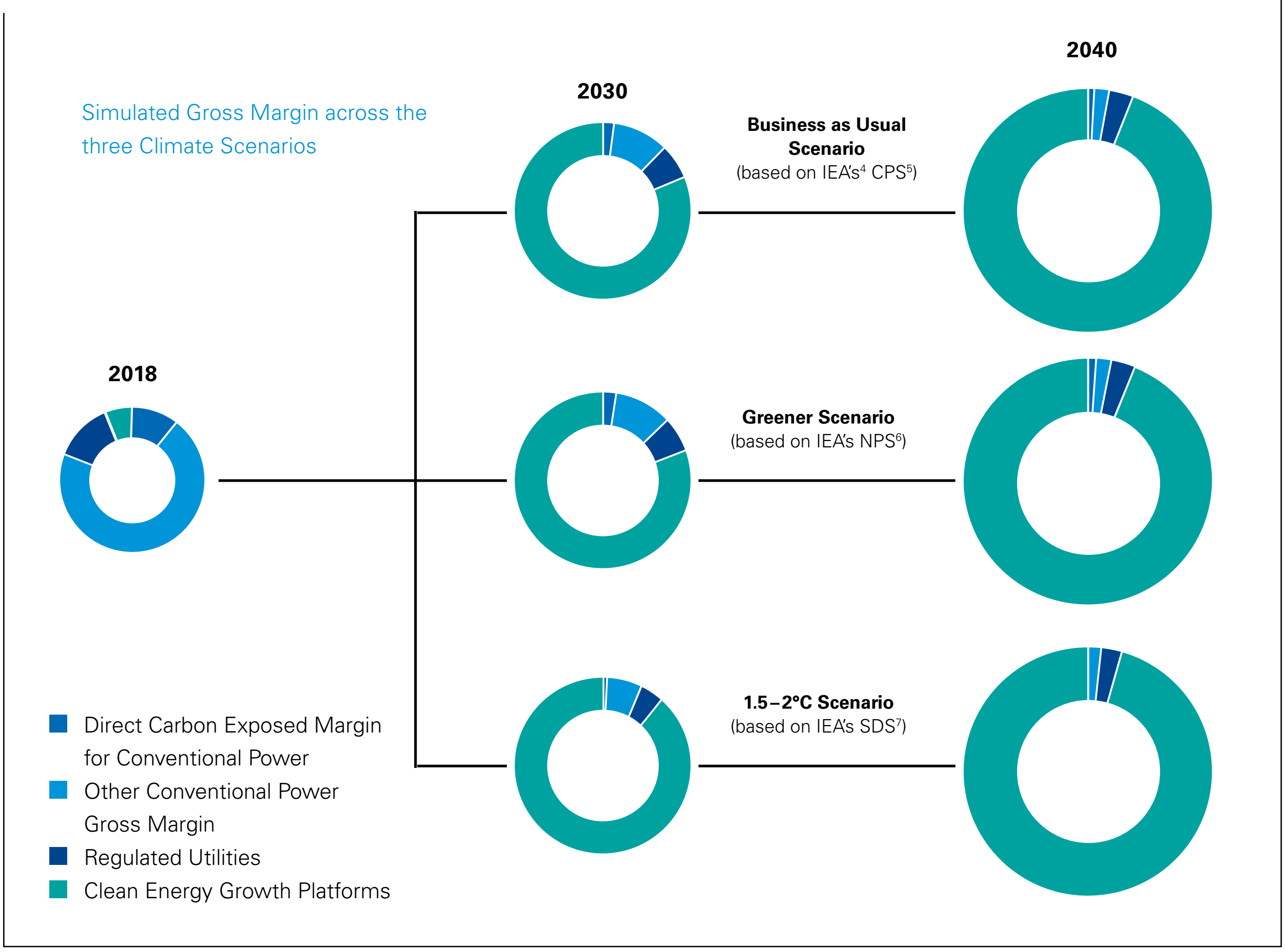
Besides climate change, other environmental and social aspects play an important role. A good example is human rights. Should the Swiss electorate agree to the RBI, a direct legal liability arises in regards to human rights. This covers a very broad field and would pose huge challenges to multinational companies who work with many sub-contractors. But even in the absence of a concrete legal liability, risks of legal action are increasing. Litigation related to business and human rights is growing. Additional pressure is also coming from stricter public procurement regulation, such as the EU Directive 2014/24/EU on Public Procurement, allowing bidders to be excluded from public procurement or terminating contracts as a consequence of grave misconduct, of using child labor or other forms of human trafficking. All kinds of other ESG-related aspects are currently implemented in public procurement policies. ESG matters can therefore not only lead to additional cost but also the loss or gain of revenue.

1 Source: Munich Re, "The natural disasters of 2018 in figures", 8 Jan 2019, and "Hurricanes cause record losses in 2017 – The year in figures," 4 Jan 2018
2 Soruce: The Economist Intelligence Unit, "The Cost of Inaction. Recognising the Value at Risk from Climate Change," 2015.

Taking ESG seriously means that boards have to really understand their exposure and the bottom-line impacts of the company's externalities. The changes in the regulatory playing field are a wake-up call to define governance structure and take action.

This includes communicating the company's profile transparently and in an appropriate manner to investors and other stakeholders.

Excerpt from the AES[3] Climate Scenario Report



Source: AES Climate scenario report

[3] The AES Corporation
[4] International Energy Agency
[5] Current Policies Scenario
[6] New Policies Scenario
[7] Sustainable Development Scenario

Important trends to consider for corporate reporting

1. Transparency about the financial impacts of ESG aspects

Pressure to improve the quality of ESG reporting is coming in particular from an awakening investor community and regulation for financial institutions around sustainable finance. The EU Commission's Action Plan on Sustainable Finance includes various regulations to reorient capital flows towards a more sustainable economy, incorporate sustainability into risk management and foster transparency.

Green products are a growing investment area that attract the interest of various investors. One new measure is a taxonomy to standardize and label green financial products. The Action Plan also includes, for example, a standard for green bonds. Such regulation will not only impact financial institutions but also lead to a need for more specific information from corporations. In order to retain access to finance, companies will need to think about the level of transparency they need to provide and strategic considerations that come with it. With more company information available, and data and analytics increasingly being used by rating agencies and analysts, it is no longer enough to just publish some general information or photo stories.

However, investors are just starting to realize that sustainable finance fulfills a dual objective. First, it aims to finance businesses or projects that can demonstrate an ESG impact, enabling the transition to a low-carbon and more sustainable economy. But second, by integrating ESG-related financial risks in their traditional risk management processes, investors get a more holistic view of how externalities, like climate change, could impact their portfolio and on that basis, take the necessary measures to address them. As a result, sustainable finance is shifting away from being considered a niche investment product to being a new way of making investment and lending decisions. Again, it is corporations that are affected. For example, asset owners have quickly ramped up efforts to implement the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD), which became a mandatory practice for signatories of the Principles of Responsible Investment in 2020. This means that those organizations will assess risks and opportunities deriving from climate change and communicate to investors the resulting financial impacts from various future scenarios. This in turn creates additional pressure on companies to disclose such impacts and to manage these risks and opportunities as well. Besides increasing demand for detailed information, the main takeaway from movements in the investor world and sustainable finance regulation is that companies will need to be able to provide transparency on the value at risk due to ESG aspects, as well as the material risks and opportunities and how these are managed.

Recommendations and Supporting Recommended Disclosures

TCFD recommendations – overview

GOVERNANCE

Disclose the organization's governance around climate-related risks and opportunities.

a) Describe the board's oversight of climate-related risks and opportunities.

b) Describe management's role in assessing and managing climate-related risks and opportunities.

STRATEGY

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.

a) Describe the climate-related risks and opportunities the organization has identified over the short, medium, and long term.

b) Describe the impact of climate-related risks and opportunities on the organization's businesses, strategy, and financial planning.

c) Describe the resilience of the organization's strategy, taking into consideration different climate-related scenarios, including a 2°C or lower scenario.

RISK MANAGEMENT

Disclose how the organization identifies, assesses, and manages climate-related risks.

a) Describe the organization's processes for identifying and assessing climate-related risks.

b) Describe the organization's processes for managing climate-related risks.

c) Describe how processes for identifying, assessing, and managing climate-related risks are integrated into the organization's overall risk management.

METRICS AND TARGETS

Disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities where such information is material.

a) Disclose the metrics used by the organization to assess climate-related risks and opportunities in line with its strategy and risk management process.

b) Disclose Scope 1, Scope 2, and, if appropriate, Scope 3 of greenhouse gas (GHG) emissions, and the related risks.

c) Describe the targets the organization strives for when managing climate-related risks and opportunities.

Source: https://www.fsb-tcfd.org/wp-content/uploads/2019/06/2019-TCFD-Status-Report-FINAL-053119.pdf)

2. Credibility is key to restore trust

Deteriorating trust in business is almost certainly one of the factors contributing to public pressure for more regulation. The Edelmann Trust Barometer 2020 found that 56% of people think that "capitalism as it exists today does more harm than good in the world". According to the barometer, business is perceived as competent but unethical. Restoring trust must therefore be a key objective for business, in particular to avoid burdensome regulation.

With a view to Switzerland's regulatory environment, the requirements that will follow from the 29 November vote – legislation based on the RBI or Parliament's counterproposal – will affect many companies. The impact will be highest for those that have not yet reported on their ESG impacts in a structured way and have not yet established full visibility of their business relationships. Companies that already report on this will also need to take action, such as considering human rights-related aspects in their operations and supply chains, or carbon emission targets, which would specifically be required by Parliament's counterproposal. But it's not about publishing as much data as possible. A clearly communicated strategy, underpinned by meaningful performance indicators, governance and targets is most important to enhance credibility of corporate reporting. Choosing the right standards supports structured and credible reporting towards the relevant stakeholders.

Independent third-party assurance can also be a powerful measure in establishing trust in your ESG reporting. So far, only about one-fifth of the 100 largest companies in Switzerland have obtained assurance on some parts of their sustainability reporting. The trend is growing towards obtaining assurance.

Credibility has definitely become a key objective for reporters.

What should boards think about?
Managing ESG aspects can make a difference for employees, customers, investors and regulators. Embracing this thought as an opportunity can be a first step. In order to prepare for the future, boards should consider five key topics now:

1. **Re-think strategic pillars and the business model:** ESG management should be clearly aligned with your business strategy. Boards should understand the implications of ESG aspects on value creation. Investors will expect you to also communicate financial impacts deriving from ESG aspects.
2. **Analyze the impact of current regulatory change:** the EU Action Plan and upcoming national regulation, including the RBI in Switzerland, may bring huge challenges to companies and risks regarding access to finance, legal liabilities and reputation. Boards need to understand the significance of such regulation for their business, allocate responsibility and take early action to establish compliance. Make sure your business reporting is prepared to cover the regulatory requirements.
3. **Invest in transparency:** ensure you have established robust reporting processes and governance structures to guarantee quality information as a decision-making basis for your leadership and your stakeholders. Transparency will need to go beyond the traditional corporate reporting and include information on supply chain and business relationships.
4. **Consider credibility:** use well-established standards and frameworks, like the GRI standards, SASB or the TCFD recommendations and make sure that your assurance provider adheres to recognized standards such as the ISAEs. To communicate clearly where you want to go, targets are key. Link them to trusted international or national regulation or standards to help make results tangible, assess performance and lend credibility.
5. **Build up trust:** ensure that your assurance concept, involving all three lines of defense, covers all material ESG aspects. Your internal and external assurance providers will need to have the right level of subject-matter expertise to provide you with appropriate trust in your performance measures and external reporting.

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