KPMG

Impact of ESG disclosures

Embracing the future

September 2019

Around the globe, voices clamoring for climate-aware investing and carbon controls are increasing. Demand for ethical treatment of employees, customers and other stakeholders is also growing, as is indignation about poorly-managed companies.

Companies are subject to an increasing set of non-financial reporting requirements relating to environmental, social and governance (ESG) factors. A swathe of new requirements will soon impact the investment and lending appetites of EU financial institutions. Coupled with increasing investor demands, these new rules could have a profound impact on companies' ability to raise capital, within the EU and beyond.

Companies need to take action now on assessing ESG risks and opportunities for their businesses and on proper ESG disclosures, in order to be prepared for these changing demands.

Direct and indirect pressures on corporates and other types of enterprises to make more detailed ESG-related disclosures are increasing. Greater transparency is, in turn, leading to increased scrutiny of companies' business and operating models, their carbon footprints and their exposure to climate change.

The revised EU Non-Financial Reporting Directive requires large entities and groups to disclose information on their development, performance and position and the impact of their activity, relating to ESG and other matters. Moreover, where the group does not pursue policies in relation to these matters, the statement must provide a clear and reasoned explanation for not doing so. Section 02 provides more detail on these requirements and other developments in non-financial reporting, at global, regional and national level.

Within the investment arena, an OECD[1] report in 2017 on investment governance and the integration of ESG factors[2] had profound implications for companies' investment decision-making processes and prompted new activity by regulators and policy makers. The key message was that ESG factors are now critical to the health and prospects of any company. Their consideration therefore sits squarely within an investing institution's fiduciary duty.

The OECD observed a growing consensus, supported by academic research, that financial markets reward good ESG performance by companies. It recognized, though, that a lack of commonly-accepted analytical methods was hampering wider integration of ESG factors into investment processes.

Two years on, the investor voice is directly influencing the European financial services regulatory agenda (see section 03), and sustainable finance has moved onto national and global regulatory agendas, too (see section 04). ESG investment strategies have become a must for institutional investors and asset managers. And banks and insurance companies are being required to include climate-related risks in stress testing exercises.

Even in those jurisdictions where no regulatory imperative on financial institutions is expected in the short-term, investor demands are driving change (see section 05). Demand for ESG funds rocketed in 2018, for example, despite difficult market conditions, which led to outflows from many other funds.

Key questions

- What impact will regulatory developments and mounting pressures from investors have on the share value and capital-raising activities of listed companies and unlisted enterprises?
- How quickly might those impacts be felt?
- What can companies do to respond to this rapidly-changing investment environment?
- In particular, what will it mean for companies that do not fall under the regulatory definition of "sustainable" or whose business models are regarded as having adverse impacts on ESG factors, such as those in high carbon-emitting sectors?

In short, the impact will be profound and has already begun. All companies need to embrace the future. Fundamental change is now an imperative for all.

[1] Organization for Economic Co-operation and Development
[2] https://www.oecd.org/finance/Investment-Governance-Integration-ESG-Factors.pdf

© 2019 KPMG International Cooperative ("KPMG International"), a Swiss entity. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved.

ESG-related requirements: a comparison

Current and developing ESG-related requirements are as diverse as the companies and entities that are subject to them. In one sense, the requirements all point to the same primary goal – to help governments meet their Paris Climate Change Agreement commitments – but they go about it in different ways and come from different perspectives:

1. Some are mainly or only about climate change; others cover the full set of ESG factors.
2. Some are primarily concerned with the health of the company in the light of the risks and opportunities posed by climate change; others are (additionally) concerned about the impact of the company on the planet or society.
3. Most consider both positive and adverse impacts (risks and opportunities), but certain requirements are focused only or mainly on adverse impacts/risks.
4. Some requirements are about disclosures; some enforce business change.
5. Some are mainly backward-looking, but most are forward-looking.
6. Some are primarily about the entity's view of its own business ("internal perspective"); others require a third party to take a view ("external perspective").

The table illustrates these differences for the main types of requirements and actors.

Point 4 is particularly important when considering the potential implications and force of the new universe of requirements. Regulations and regulators that are concerned only about disclosures cannot directly enforce business change. However, stakeholders' reactions to those disclosures could lead the entity to review its business model – a "second order" effect.

In contrast, much financial services regulation requires not only disclosures but also for authorized entities to go about their business in a different way, be it policies, processes or additional capital requirements. It will therefore have a first order effect on authorized firms' business models, which will in turn have a strong second order impact on other parties.

The ESG-related disclosures of corporates and sovereign bodies seeking to raise capital (or maintain share value) will come under an intense spotlight. The impact will be on any form of capital-raising – equities, fixed income, derivatives, borrowing, or private financing. Moreover, capital-raisers could be forced to supplement their mandatory disclosures in order to meet the wider-ranging demands of financial services firms.

Summary comparison of ESG requirements

This table is for illustrative purposes, it is not a definitive representation of all ESG-related requirements. There are various nuances or additional requirements for different sectors or for different aspects of the rules, and the requirements may be implemented differently across jurisdictions.

Legal/mandatory requirements			Public reporting requirements for corporates		Stewardship requirements	Financial Services regulation and supervisory requirements			
A		B	Financial	Non-financial	Institutional Investors & Asset Managers	Institutional Investors & Asset Managers	Credit Rating Agencies & Benchmarks	Retail distributors ("suitability")	Banks & Insurers (stress testing)
Climate change, only/ mainly	vs.	All ESG factors	A	B	B	B	B	B	A*
Company health	vs.	Planetary & societal impacts	A	A+B	A	A+B	A+B	A+B	A
Positive impacts	vs.	Adverse impacts	A+B	A+B	A+B	A+B	A+B	A+B	B
Mandatory disclosures	vs.	Enforced business change	A	A	B	A+B	A+B	B	B
Backward-looking (mainly)	vs.	Forward-looking	A	A+B	B	B	B	B	B
Internal perspective	vs.	External perspective	A	A	B	B	B	B	A

* This table entry is based on certain national supervisory requirements (e.g. the UK PRA), but the European Commission is currently tendering for a project on the embedding of ESG risks (i.e. not just climate change) in banks' risk management systems.

Contact us

Julie Patterson
Head of Asset Management, Regulatory Change
FS Risk & Regulatory Insight Centre, EMA
T: +44 20 73112201
E: julie.patterson@kpmg.co.uk

© 2019 KPMG International Cooperative ("KPMG International"), a Swiss entity. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

Designed by Create Graphics | CRT117773