



Impact of ESG disclosures

Embracing the future

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Contents

01. Introduction	04
02. Corporate ESG-related disclosures	06
03. Far-reaching EU FS regulation	10
04. National responses to ESG vary	14
05. Investor demands drive institutional behavior	16
06. Climate change: risks and opportunities	17
07. The time to act is now	18

01 Introduction

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 OECD¹ report in 2017 on investment governance and the integration of ESG factors² 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>

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			
		Financial	Non-financial		Institutional Investors & Asset Managers	Institutional Investors & Asset Managers	Credit Rating Agencies & Benchmarks	Retail distributors ("suitability")
A	B							
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.

02 Corporate ESG-related disclosures

A global task force finds that climate-related financial disclosures are increasing but are still too few in number and insufficiently detailed. Standard-setting bodies are seeking to enhance and align their approaches. Meanwhile, the European Commission has issued guidelines for companies and financial institutions on non-financial climate-related disclosures, and some national regulators are already taking action.

The June 2019 status report³ of the global Task Force on Climate-related Financial Disclosures (TCFD) delivered a robust message: disclosures have increased since 2016, but are still insufficient for investors. Michael Bloomberg, TCFD Chair said, “Today’s disclosures remain far from the scale the markets need to channel investment to sustainable and resilient solutions, opportunities, and business models”. The findings are based on reviews of over 1,000 large companies in multiple sectors and regions over a three-year period.

The TCFD, set up in December 2015 by the Financial Stability Board (FSB), is tasked with monitoring and making recommendations on risks to the global financial system. The TCFD has developed voluntary, consistent climate-related financial disclosures that are useful in understanding companies’ material risks related to climate change. Nearly 800 public- and private-sector organizations have announced their support for the TCFD and its work, including global financial firms responsible for assets in excess of USD 118 trillion.

“Today’s disclosures remain far from the scale the markets need to channel investment to sustainable and resilient solutions, opportunities, and business models”

The status report notes that, “Given the urgent and unprecedented changes needed to meet the goals of the Paris Agreement, the Task Force is concerned that not enough companies are disclosing information about their climate-related risks and opportunities.” The TCFD recognizes the challenges that companies face in making such disclosures and encourages them to use its recommendations as a framework to guide their efforts.

Additional work is being considered in three areas:

- Clarifying elements of guidance contained in the annex to its 2017 report
- Developing process guidance around how to introduce and conduct climate-related scenario analysis
- Identifying business-relevant and accessible climate-related scenarios

Global initiatives

A number of initiatives are underway, which are seeking to address the TCFD’s concerns. KPMG member firm specialists are directly involved in this work.

The International Accounting Standards Board (IASB) is expected to publish in the first half of 2020 an Exposure Draft with updates to the 2010 IFRS Practice Statement 1: Management Commentary. The project, announced in November 2017, is considering how broader financial reporting could complement and support IFRS financial statements. The Board noted that the revision of the Practice Statement is intended to promote preparation of management commentaries that better meet the information needs of the primary users of financial reports. It will provide guidance that:

- consolidates innovations in narrative reporting
- addresses gaps in reporting practice
- remains principles-based but contains sufficient detail to support rigorous application

The Board is also considering how the qualitative characteristics of useful financial information should be considered in preparing management commentaries.

In a speech in April 2019⁴, the Chair of the Board, Hans Hoogervorst addressed what sustainability reporting can and cannot achieve, and how it relates to financial reporting.

³ <https://www.fsb.org/wp-content/uploads/P050619.pdf>

⁴ <https://www.ifrs.org/news-and-events/2019/04/speech-iasb-chair-on-sustainability-reporting/>



TCFD: key themes and findings

Disclosure of climate-related financial information has increased since 2016, but is still insufficient for investors. Based on the TCFD survey, the artificial intelligence review, and input from external initiatives, the Task Force sees progress being made to improve the availability and quality of climate-related financial information.

However, given the speed at which changes are needed to limit the rise in the global average temperature – across a wide range of sectors – more companies need to consider the potential impact of climate change and disclose material findings.

More clarity is needed on the potential financial impact of climate-related issues on companies. The top area identified by users of climate-related financial disclosures as needing improvement is for companies to provide more clarity on the potential financial impact of climate-related issues on their businesses. Without such information, users may not have the information they need to make informed financial decisions.

Of companies using scenarios, the majority do not disclose information on the resilience of their strategies. Three out of five companies responding to the TCFD survey that view climate-related risk as material and use scenario analysis to assess the resilience of their strategies do not disclose information on the resilience of their strategies. This is an important gap in disclosure for companies with material climate – related risks, but it is consistent with the Task Force’s understanding from discussions with various companies, industry associations, and other groups that companies are still early in the process of using climate-related scenarios internally, evolving their approaches, and learning how to integrate scenarios into corporate strategy formulation processes.

Mainstreaming climate-related issues requires the involvement of multiple functions. While sustainability and corporate responsibility functions are the primary drivers of TCFD implementation efforts, risk management, finance, and executive management are increasingly involved as well. The Task Force believes involvement of multiple functions is critical to mainstreaming climate-related issues, especially the involvement of the risk management and finance functions.

Source: TCFD status report, June 2019



He noted that reporting that helps investors understand how companies are affected by sustainability issues offers a promising step forward, but he cautioned against exaggerated expectations for sustainability reporting as a catalyst for change in the absence of policy and political intervention. “Our Standards do not seek to portray the contribution of a company to the public good, but to provide information that helps investors in their efforts to predict future cash flow of the company itself”, he said.



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He further noted that where climate-related risks could have a significant impact on a company’s operations, information about how this has been factored into impairment calculations would be relevant to the users of the financial statements. As the effects of climate change become more prominent, they will become more and more visible in the financial statements. Many sustainability issues may only emerge in the long run, though, and will tend to escape the financial statements, which are essentially backward-looking. However, broader financial reporting can play an important role even in these cases.

One of Mr. Hoogervorst’s key observations was that “there are simply too many standards and initiatives in the space of sustainability reporting. This leads to a lot of confusion among users and companies themselves.” The Better Alignment Project of the Corporate Reporting Dialogue is seeking to address this issue. Its initial findings are due to be published in September 2019.

In the first year, the project participants⁵ are mapping their frameworks against the TCFD recommendations, with a view to aligning their metrics in future where possible, taking into account the different focuses and audiences. The first year’s report will also explain how the frameworks fit together and complement each other, and will identify areas for future work.

EU requirements expand

For financial years starting on or after 1 January 2017, the revised EU Non-Financial Reporting Directive requires large entities and groups to include in their consolidated management report specific ESG-related reporting.

⁵ CDP, the Climate Disclosure Standards Board, the Global Reporting Initiative, the International Integrated Reporting Council and the Sustainability Accounting Standards Board.

The Directive applies to public-interest entities that are parent undertakings of a large group that on its balance sheet date, on a consolidated basis, has an average number of more than 500 employees during the financial year. The consolidated non-financial statement contains “information to the extent necessary for an understanding of the group’s development, performance, position and impact of its activity, relating to, as a minimum, environmental, social and employee matters, respect for human rights, anti-corruption and bribery matters”, including:

- a. brief description of the group’s business model
- b. a description of the policies pursued by the group in relation to those matters, including due diligence processes implemented
- c. the outcome of the policies
- d. the principal risks related to those matters linked to the group’s operations including, where relevant and proportionate, its business relationships, products or services that are likely to cause adverse impacts in those areas, and how the group manages those risks
- e. non-financial key performance indicators relevant to the particular business

Where the group does not pursue policies in relation to one or more of those matters, the consolidated non-financial statement must provide a clear and reasoned explanation for not doing so.

Entities must also disclose: a description of the diversity policy applied in relation to the undertaking’s administrative, management and supervisory bodies with regard to aspects such as age, gender, or educational and professional backgrounds; the objectives of that diversity policy; how it has been implemented; and the results in the reporting period. Again, if no such policy is applied, the statement must contain an explanation as to why this is the case.

As part of its Sustainable Finance Action plan,⁶ the European Commission has now issued guidelines⁷ to provide practical recommendations on reporting the impact of economic activities on the climate and of climate change on businesses.

The guidelines integrate the recommendations of the TCFD and build on the EU Technical Expert Group’s recommendations (see section 03). They are intended for use by firms that are in the scope of the EU Non-Financial Reporting Directive, but could have wider application. They include a limited number of recommended climate-related disclosures for each of the five reporting areas under the Directive: business model, policies and due diligence, outcome of policies, principal risks and risk management, and key performance indicators. Firms are expected to follow the recommended disclosures to the extent they are necessary

for an understanding of the development, performance, position and impact of their activities.

Firms are also expected to disclose information in accordance with widely-accepted reporting standards and frameworks to maximize comparability for stakeholders. To facilitate consistent reporting at EU and global levels, the guidelines refer to a number of recognized reporting frameworks and standards, which are within the fold of the Corporate Reporting Dialogue (see above).

Enhanced national requirements

National regulators are also taking action. In addition to reporting requirements, listing rules and stewardship codes are being enhanced with explicit references to climate-change related financial disclosures.

The **Australian** Accounting Standards Board published in December 2018 a paper that discusses when climate-related disclosures are material, and therefore should be included within the IFRS financial statements.⁸ The paper mentions that in particular industries, the carrying value of assets – such as property, plant and equipment and assets recognized in relation to mineral resources – could be overstated if the impact of climate-related risks is not properly taken into account.

The **UK** Financial reporting Council consulted⁹ in early 2019 on changes to the UK Stewardship Code. In particular, it proposed additional guidance to Principle 4, which requires institutional investors to establish clear guidelines on when and how they will escalate their stewardship activities. The proposed guidance says, “Instances when institutional investors may want to intervene include, but are not limited to, when they have concerns about the company’s strategy, performance, governance, remuneration or approach to risks, including those that may arise from social and environmental matters.” It adds, “Initial discussions should take place on a confidential basis. However, if companies do not respond constructively when institutional investors intervene, then institutional investors should consider whether to escalate their action”.

The **China** Securities Regulatory Commission, in collaboration with the Ministry of Environmental Protection, has introduced new requirements that all, by 2020, listed companies and bond issuers must disclose ESG risks associated with their operations. The Securities and Futures Commission (SFC) in Hong Kong (SAR), China said that although much work has been done in facilitating green bonds, other important areas of green finance have been neglected.¹⁰ “We need to catch up to become a leader in a hitherto niche area which will shortly become an important component of mainstream finance”, the head of the SFC said in September 2018. The SFC is now focusing on environmental disclosure by listed companies.

⁶ https://ec.europa.eu/info/publications/180308-action-plan-sustainable-growth_en

⁷ https://ec.europa.eu/info/business-economy-euro/company-reporting-and-auditing/company-reporting/non-financial-reporting_en

⁸ https://www.aasb.gov.au/admin/file/content102/c3/AASB_AUASB_Joint_Bulletin_13122018_final.pdf

⁹ <https://www.frc.org.uk/getattachment/b11e40ec-7d2e-4acb-9619-ae210fc9ac18/Annex-B-Proposed-Revisions-to-the-UK-Stewardship-Code-2012-vs-2019-Jan-2019.pdf>

¹⁰ https://www.sfc.hk/web/EN/files/ER/PDF/Speeches/Ashley_20180919.pdf

03 Far-reaching EU regulation

EU financial services regulation is leading the way and is expected to have far-reaching effects. Institutional investors (including insurance companies and pension funds), asset managers and managers of collective investment funds are all in scope. The new requirements will have significant ramifications for all types of companies and enterprises in which they invest, within the EU and beyond.

Also, two new categories of low-carbon benchmarks have been created, disclosures by EU credit rating agencies are being enhanced, and banks and insurers are being required to pay greater attention to climate-related risks in their stress testing exercises.

The European Commission appointed in 2016 a High-Level Expert Group (HLEG) to support development of an overarching and comprehensive EU strategy on sustainable finance. In its interim report of July 2017, the HLEG identified two imperatives for Europe's financial system: to strengthen financial stability and asset pricing, by improving the assessment and management of long-term risks and intangible factors of value creation; and to improve the contribution of the financial sector to sustainable and inclusive growth by financing long-term needs and accelerating the shift to a sustainable economy.

In response, the Commission released in May 2018 a package of legislative proposals:¹¹

- Harmonized criteria (taxonomy) for determining whether an economic activity is “environmentally-sustainable”
- Disclosure requirements for institutional investors and intermediaries
- The creation of new categories of low-carbon benchmarks
- Amendments to the Markets in Financial Instruments Directive (MiFID II) and the Insurance Distribution Directive (IDD) to integrate ESG considerations into “suitability” tests

Defining E, S and G

A key part of the package is a Regulation to establish the criteria for determining whether an economic activity is “environmentally-sustainable” – the Taxonomy. This focus on the E of ESG is marked. In contrast, the S and G factors receive only short references in the separate regulation on disclosures (see page 11).

For an activity to be environmentally-sustainable, it must contribute substantially to one or more of these objectives, not significantly harm any of them, and comply with minimum safeguards and technical screening criteria, which will be set out in a Delegated Act. The main body of the rules will start to apply between July 2020 and December 2022.

The Taxonomy Regulation sets out six environmental objectives:

1. climate change mitigation
2. climate change adaptation
3. sustainable use and protection of water and marine resources
4. transition to a circular economy, waste prevention and recycling
5. pollution prevention and control
6. protection of healthy ecosystems

Disclosures to investors and beneficiaries

The Sustainability-related Disclosures Regulation requires financial market participants and financial advisers to make disclosures on the integration of sustainability risks (SRs) and the consideration of adverse sustainability impacts in their processes and the provision of related information on financial products (including funds and pension products).

Financial market participants must publish on their websites their policies on the integration of SRs in their investment decision-making process. They must also publish whether they consider adverse impacts of investment decisions on sustainability factors and, if they do, their due diligence policies, including the identification, prioritization and description of principal adverse sustainability impacts, and action taken or planned. If they do not perform such considerations, they must state that they do not so, their reasons for not doing so, and whether and when they intend to do so.

¹¹ http://europa.eu/rapid/press-release_MEMO-18-3730_en.htm



EU definitions of sustainable investments and sustainability risks

Sustainable investments mean any of the following or a combination of any of the following:

- (i) investments in an economic activity that contributes to an environmental objective, including an environmentally sustainable investment as defined in Article 2 of the Taxonomy Regulation;
- (ii) investments in an economic activity that contributes to a social objective, and in particular an investment that contributes to tackling inequality, an investment fostering social cohesion, social integration and labor relations, or an investment in human capital or economically or socially disadvantaged communities;

Provided that the investments do not significantly harm any of those objectives and the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of relevant staff and tax compliance.

Sustainability risk is defined as an ESG event or condition that could cause an actual or potential negative impact on the value of the investment arising from an adverse sustainability impact.

Pre-contractual disclosures (e.g. fund prospectuses) must include descriptions of the manner in which SRs are integrated into their investment decisions and assessment of the likely impacts of SRs on the returns of financial products, or a clear and concise explanation of why SRs are not relevant.

Financial products that have sustainable investment objectives must disclose methodologies used to assess, measure and monitor the E or S characteristics, or the impact of the sustainable investments. If a product has designated an index, it must disclose how the index is aligned to the objective and why it differs from a broad market index.

By 2022, each financial product will have to disclose a clear and reasoned explanation of whether, and if so how, it considers principal adverse impacts of sustainability factors, or why it does not do so.

Low-carbon benchmarks

The EU Benchmarks Regulation has been amended to include references to “low-carbon benchmarks” (which have less carbon emissions compared to a standard capital-weighted benchmark) and “positive carbon impact benchmarks” (for which the underlying assets are selected on the basis that their carbon emissions savings exceed the assets’ carbon footprints). Two new benchmarks have been created: the EU Climate Transition Benchmark (CTB) and the EU Paris-aligned Benchmark (PAB).

“

disclosures on the integration of sustainability risks (SRs) and the consideration of adverse sustainability impacts

”

New EU benchmarks

CTB: The underlying assets are “selected, weighted and excluded in such a manner that the resulting portfolio is on a decarbonisation trajectory”:

- i. Companies disclose measurable and time-based carbon emission reduction objectives
- ii. Companies disclose a carbon emission reduction, which is disaggregated down to the level of relevant operating subsidiaries
- iii. Companies disclose annual information on progress made towards those objectives
- iv. The activities of the underlying assets do not significantly harm other ESG objectives

A decarbonisation trajectory means a “measurable, science-based and time-bound trajectory to reduce scope 1, 2 and 3 carbon emissions towards the alignment with the long-term warming target of the Paris Climate Agreement”.

PAB: The underlying assets are “selected in such a manner that the resulting benchmark portfolio’s carbon emissions are aligned with the long-term global warming target of the Paris Climate Agreement.”

For each benchmark or family of benchmarks (excluding currency and interest rate benchmarks), an explanation must be given of how the key elements of the methodology reflect ESG factors. Exclusions will include, for example, companies that are associated with a level of carbon footprint or fossil fuel reserves that is incompatible with inclusion in the benchmark. If a benchmark does not pursue ESG objectives, this must be clearly stated. Further detail will be specified in Delegated Acts on the criteria for choice of underlying assets, and the criteria and methodology for writhing those assets.

Suitability tests

Under the amended MiFID II and IDD Delegated Regulations, intermediaries must seek information about and have regard to clients’ ESG preferences.

In its May 2019 technical advice to the Commission on amendments to the Solvency II Directive and IDD, the European Insurance and Occupational Pensions Authority (EIOPA) notes, “The assessment of sustainability risks requires deep knowledge of the undertaking’s business, the external environment and the interaction between both. For such purpose, relevant knowledge may include a wide range of different areas such as ecology, law, sociology, financial markets, among others.”

At the same time, the European Securities and Markets Authority (ESMA) issued its final advice¹² to the Commission on Level 2 amendments to MiFID II, which include:

- Taking ESG preferences into account when assessing clients’ investment objectives and in product classification
- Requiring managers of UCITS and Alternative Investment Funds to incorporate SRs into their internal procedures and investment processes, and to identify and manage conflicts of interest
- Minimum disclosure requirements on whether and how ESG factors were included in credit ratings

Asset managers will have to set up new controls and potentially hire more staff, ESMA said, noting that firms need to have “sufficient human and technical resources for the assessment of sustainability risks”. Also, remuneration policies must be linked to sustainability risks and targets, all policies and documentation need to be reviewed and amended, and both pre-contractual and periodic disclosures to investors will need to be augmented.

ESMA has also established a Coordination Network on Sustainability, which will work with national regulators on policy development and integration of sustainability considerations in financial regulation.

Legislative state-of-play

The European Parliament and the Council have adopted the disclosure requirements (implementation by autumn 2020, with later deadlines in certain areas) and the new categories of low-carbon benchmarks (implementation by April 2020). Also issued as final are the amendments to the Delegated Acts under MiFID II and the IDD.

The co-legislators have still to agree the Taxonomy Regulation. A particular sticking point is that there are strong views for and against mandating requirements in Level 1 regulation. Sustainable finance will continue to be a key objective of the new Commission. However, with many new faces in the Parliament, a very different mix and balance of political groupings, the new Finnish Council Presidency and a new Financial Services Commissioner awaited, the path to adoption of the Regulation will not be straightforward.

Meanwhile, the Commission is considering the introduction of an eco-label to encourage retail savers to buy green investments.

Technical Expert Group reports

To assist development of the technical aspects of its proposals, the Commission established a Technical Expert Group (TEG) on Sustainable Finance. In June 2019, the TEG issued three reports:

- A **classification system** (taxonomy) for environmentally-sustainable economic activities based on events across a wide range of sectors.¹³ It aims to provide practical guidance for policy makers, industry and investors on how best to support and invest in economic activities that contribute to achieving a climate neutral economy.

¹² <https://www.esma.europa.eu/press-news/esma-news/esma-consults-measures-promote-sustainability-in-eu-capital-markets>

¹³ https://ec.europa.eu/info/files/190618-sustainable-finance-teg-report-taxonomy_en

- An **EU Green Bond Standard**¹⁴ – clear and comparable criteria for determining which climate and environmentally-friendly activities should be eligible for funding via an EU green bond. There are ten recommendations relating to establishing the Standard and the ways in which European governments and institutions, market participants and other stakeholders can support and monitor its implementation. Building on best market practices, the proposed Standard aligns with the Taxonomy Regulation, encompasses mandatory reporting (on use of proceeds/environmental impact) and includes verification of the Green Bond Framework.
- **EU climate benchmarks and benchmarks' ESG disclosures** – interim recommendations¹⁵ on the methodology and detailed technical guidance on minimum standards for the two new types of benchmark. The report also sets out minimum disclosure requirements to improve transparency and comparability of information across all benchmarks, on a variety of ESG factors and their alignment with the Paris agreement. The aim is to enable investors to adopt a climate-conscious investment strategy and to address the risk of “greenwashing” – making an unsubstantiated or misleading claim about a product, so that it appears more environmentally-friendly.

The TEG's mandate has been extended until the end of 2019, allowing time for further refinement and development of the proposals.

Credit rating disclosures

In July 2019, ESMA issued technical advice¹⁶ to the European Commission, under the Credit Rating Agencies (CRA) Regulation, on sustainability considerations in the credit rating market. It also issued final guidelines that require CRAs to disclose when ESG factors have been a driver in changing a credit rating or outlook.

ESMA notes that whether developments in relation to the consideration of ESG factors by CRAs are market driven or public policy driven, CRAs would appear to be aware that this is an issue of growing importance to which they will need to devote greater resources over the coming years.

Stress testing by banks and insurers

Meanwhile, there is increasing pressure for banks and insurers to incorporate the full panoply of climate change risks in their stress testing exercises.

In April 2019, the **UK's** Prudential Regulatory Authority issued a Supervisory Statement¹⁷ on its expectations for banks and insurers to submit by October 2019 plans to protect themselves from financial risks associated with climate change. Firms will need to embed climate change within the existing governance framework and assign board-level accountability for oversight. CROs will need to consider long-term scenario testing to inform the firm's strategic response to climate change and build climate change risk into risk management processes.

The European Commission has issued a tender for work on integrating ESG risks into banks' risk management processes and EU prudential supervision, and integrating ESG objectives into banks' business strategies and investment policies.

It is not yet clear what impact this will have on banks' corporate finance and lending activities, but change seems inevitable and will impact capital-raising enterprises.



¹⁴ https://ec.europa.eu/info/files/190618-sustainable-finance-teg-report-green-bond-standard_en

¹⁵ https://ec.europa.eu/info/files/190618-sustainable-finance-teg-report-climate-benchmarks-and-disclosures_en

¹⁶ <https://www.esma.europa.eu/press-news/esma-news/esma-advises-credit-rating-sustainability-issues-and-sets-disclosure>

¹⁷ <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/policy-statement/2019/ps1119.pdf?la=en&hash=CD95D958ECD437140A4C7CF94337DAFD8AD962DE>

04 National responses to ESG vary

Individual jurisdictions are taking different approaches to sustainable finance. Some governments have developed over-arching strategies, some financial regulators have adopted specific requirements, and some have to date tended to leave it to market forces. Whatever the chosen approach, the volume of activity adds to the pressure on corporates to respond.

France led the way in legislative requirements. Since June 2017, institutional investors and fund management companies have had to report on their website and in their funds' annual reports how they take into account ESG factors. Also, two certification tools were created for financial products that integrate ESG criteria.

Under the new "PACTE" Bill, the French financial services regulator, the AMF will take responsibility for ensuring the quality of information provided by asset managers on their low-carbon strategy and their management of climate change-related risks. In November 2018, the AMF published a roadmap to sustainable finance and created a new Strategy and Sustainable Finance Unit, and in July 2019 it issued findings from a short thematic inspection of asset managers.¹⁸

The **Guernsey** Green Fund designation was developed in July 2018 by the Financial Services Commission to identify investment vehicles that meet its eligibility criteria for green investing.¹⁹ A "green kitemark" can be used if a fund either provides a certificate from an independent third party that the fund prospectus meets the criteria or secures a signed declaration from the fund administrator.

At least 75 percent of assets must be made with the objective of mitigating environmental damage, resulting in a net positive outcome for the environment. The assets must be in a defined set of asset classes including renewable energy, energy efficiency and low-carbon technologies. The remaining assets must not impair the overall objective or be made in a proscribed asset class such as waste landfills, fossil fuels or uranium mining.

In October 2018, **Luxembourg** published its Sustainable Finance Roadmap, contributing to the Agenda 2030 and to the objectives of the Paris Agreement. Building on the Luxembourg Green Exchange launched in 2016, Luxembourg also created a legal framework for green covered bonds linked to renewable energy projects.

The **Swedish** regulator, Finansinspektionen argues that sustainability-related risks and opportunities do not differ from other risks and opportunities linked to financial firms'

operations. Sustainability should not be managed in limited areas of corporate governance, it says, but rather be part of corporate governance as a whole.²⁰ In November 2018 it surveyed how 67 firms communicate information about integrating sustainability into their governance. It found that efforts are progressing, but that many firms need to work on this area. The regulator observed that it is difficult to interpret how sustainability policies are integrated at an operational level and whether these policies have an effect.

In **Belgium**, the financial regulator issued in March 2019 a quality standard for ESG investment products. And in the **Netherlands**, one of the financial regulator's 2019 priorities is sustainability, specifically reporting on sustainable investment products. It intends to take measures if reporting is incorrect, unclear or misleading. It is also analyzing the growing market for sustainable bonds and the risks.

In Hong Kong (SAR), **China** the SFC is examining asset managers' integration of ESG factors into investment processes. It is no longer enough, said the SFC, for asset managers simply to say they take ESG factors into account without disclosing a robust methodology to investors. It is further looking at developing consistent disclosure or labeling guidelines for green investment products.

In the **UAE**, Abu Dhabi Global Markets unveiled a Sustainable Finance Agenda during a forum held in Sustainability Week, in January 2019.²¹ It has four aims:

- To become a hub for sustainable finance activities by building sustainability into its regulatory framework
- To create dialogue with local and international government bodies to promote green and sustainable investments in the UAE and regionally
- To commit to increasing the level of knowledge, awareness and acceptance of sustainable finance across the UAE
- To develop a sustainable finance framework within the market and within the products and services it offers

¹⁸ https://www.amf-france.org/en_US/Actualites/Communiqués-de-presse/AMF/annee-2019?docId=workspace%3A%2F%2FSpacesStore%2Fd7cd532f-933d-462c-b0d0-03d994994b3f

¹⁹ <https://www.weareguernsey.com/news/2018/guernseys-new-green-fund-certification-boosts-a-growing-asset-class/>

²⁰ <https://www.fi.se/en/published/reports/reports/2018/integration-of-sustainability-in-corporate-governance/>

²¹ <https://www.adgm.com/mediacentre/press-releases/adgm-launches-the-sustainable-finance-agenda-to-develop-vibrant-sustainable-finance-and-investments-hub/>

The **US** Commodity and Future Trading Council has established the Climate-Related Market Risk Subcommittee, which will identify and examine the risks that climate change poses to the stability of the US financial system and develop plans to address those threats.

The **UK's** Green Finance Strategy²² was launched in July 2019 and has two objectives: to align private sector financial flows with clean, environmentally-sustainable and resilient growth, supported by Government action; and to strengthen the competitiveness of the UK financial sector. These are underpinned by three pillars:

- “Greening Finance”: ensuring current and future financial risks and opportunities from climate and environmental factors are integrated into mainstream financial decision-making, and that markets for green financial products are robust in nature. Four UK regulators published a joint statement outlining specific regulatory measures.
- “Financing Green”: accelerating finance to support the delivery of the UK’s carbon targets and clean growth, resilience and environmental ambitions, and of international objectives.
- “Capturing the Opportunity”: ensuring UK financial services capture the domestic and international commercial opportunities arising from the greening of finance, such as climate-related data and analytics, and from financing green, such as new green financial products and services.

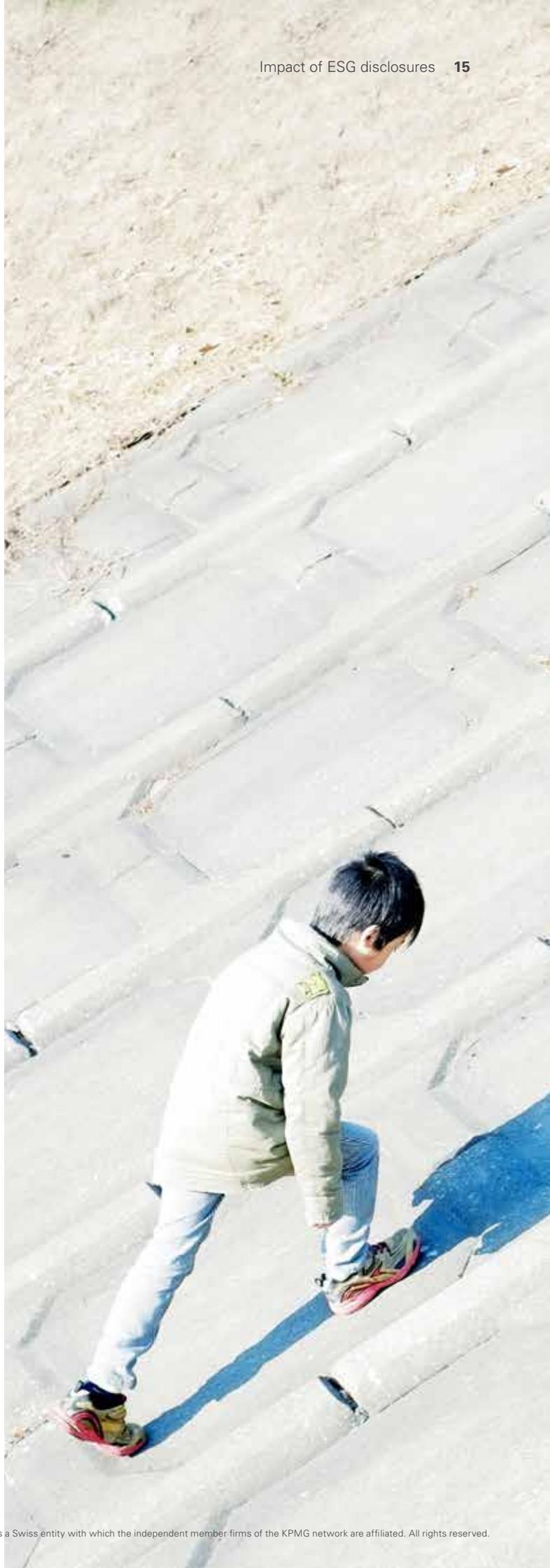
Emerging markets flex green muscles

In February 2019, the International Organization of Securities Commissions published a two-month consultation²³ on sustainable finance in emerging markets. It provided an overview of the initiatives that regulators, stock exchanges, policy makers and other key stakeholders in emerging markets have undertaken in this area and set out a number of recommendations:

- Integration by issuers and regulated entities of ESG-specific issues in their overall risk appetite and governance
- ESG-specific disclosures and reporting
- Better data quality
- Definition of eligible activities
- Integration of ESG-specific issues into the investment analysis of institutional investors
- Building capacity and expertise for ESG issues

²² <https://www.gov.uk/government/publications/green-finance-strategy>

²³ <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD621.pdf>



05 Investor demands drive institutional behavior

The demands of institutional investors are driving change for asset managers and capital-raising enterprises. They are applying pressure on asset managers to declare or articulate better how they are integrating ESG factors into their investment process. Professional investors are skeptical about regulatory prescription but the impact of their demands is being increasingly felt in the capital markets.

In **Germany**, the number of institutional investors that incorporate sustainability into their portfolios is rising but acceptance of ESG was growing more slowly than in other European countries, according to a survey conducted in 2017.²⁴ Some 65 percent took into account sustainability criteria when choosing investments, compared with 48 percent in 2013.

In the **US**, large proxy advisers are encouraging ESG in institutional investment. ISS and Glass Lewis issued new guidelines on gender diversity, environment oversight, director “over-boarding” and executive compensation.²⁵ However, other voices in the US are demanding that these and other proxy advisers are reined in, amid concerns that ESG emphasis is reducing the competitiveness of US companies through increased costs and compliance.

In July 2018, six sovereign wealth funds (SWFs) from **Abu Dhabi, Kuwait, New Zealand, Norway, Saudi Arabia and Qatar**, with assets totaling over USD 3 trillion, launched the One Planet SWF Framework.²⁶ The purpose of the Framework is to accelerate the integration of climate change analysis into the management of large, long-term and diversified asset pools. To improve the resilience and sustainable growth of these pools, the Framework aims to help SWFs:

- To foster a shared understanding of key principles, methodologies and indicators related to climate change
- To identify climate-related risks and opportunities in their investments
- To enhance their investment decision-making frameworks to better inform their priorities as investors and participants in financial markets

In July 2019, eight global asset managers launched the One Planet Asset Managers Initiative, which supports the Framework. The Framework urges asset managers to encourage companies to provide climate change-related data using standardized methodologies in a consistent format, such as adhering to the TCFD’s recommendations (see section 02).

Investor skepticism about regulatory intervention

While investors’ ESG demands are increasing, there is skepticism about regulatory intervention. A pan-European survey by the Chartered Financial Analyst Institute sums up the challenge.²⁷ Most, but by no means all, institutional investors believe sustainability should be incorporated into portfolios. However most, but not all, investors believe that ESG measures should not be mandated.

The One planet SWF Framework’s three principles

Principle 1: Alignment - Build climate change considerations, which are aligned with the SWFs’ investment horizons, into decision-making.

Principle 2: Ownership - Encourage companies to address material climate change issues in their governance, business strategy and planning, risk management and public reporting to promote value creation.

Principle 3: Integration - Integrate the consideration of climate change-related risks and opportunities into investment management to improve the resilience of long-term investment portfolios.

²⁴ http://www.union-investment.es/home/Competencies/Responsible-Investment/2017_sustainability_study.html

²⁵ <http://www.canadianminingjournal.com/features/whats-new-for-2019-proxy-season-iss-and-glass-lewis-updates/>

²⁶ <https://oneplanetwfs.org/>

²⁷ <https://www.cfainstitute.org/advocacy/issues/esg-sustainable-investing>

06 Climate change: risks and opportunities

The business implications of climate change are complex and vary across sectors. A company can at the same time face both significant climate-related business opportunities and significant financial risks in different parts of its value chain.

In order to reduce greenhouse gas emissions to meet the Paris agreement, a large part of the world's known fossil fuel reserves will need to remain in the ground. That is challenging for the financial system because investors hold bonds and shares connected to those assets. EUR trillions of assets run the risk of becoming stranded.

For example, **Germany** plans to close all the country's 84 coal-fired power plants by 2038. In July 2019, an influential group of investors, which are members of the Institutional Investors Group on Climate change and the Climate Action 100+, asked big European construction materials companies to commit to a target of reducing their net carbon dioxide emissions to zero by 2050.

Climate change affects the availability of water resources, fertility of soil and in general living conditions. This leads to what the Governor of the Bank of England, Mark Carney has called "liability risk" – that is the risk that big greenhouse gas emitters are sued by those suffering from climate change and will face court-ordered damages. Several **US** states, major cities and charities have begun to take legal action against fossil fuel companies, for example. Climate refugees and unpredictable political actions would add to this.

Opportunities for some

The transition towards a carbon neutral world will, though, see many winners, as well as those actors facing mainly risks. Business solutions that replace emissions-intensive products and services, or that are net emission negative, are in increasing demand as efforts intensify to keep climate change at a tolerable level.

Corporates in the renewable resources, energy efficiency, circular economy, assets sharing and carbon sinks management business have the opportunity to do good business and at the same time be part of the solution. The investments in low- and no-carbon solutions needed to meet the Paris agreement alone are huge, estimated at an additional EUR 180 billion annually. This market will see many sustainable and innovative businesses be successful. Green bonds, green loans and other forms of new sustainable finance will be available to finance business expansion.



07 The time to act is now

The developments described in this paper all point in one direction: more and better information is needed from companies to meet investors' demands and to meet regulatory requirements.

Few companies have a history in assessing ESG-related risks and opportunities in financial terms. Information provided to the capital markets is therefore starting from a modest level. Yet, the stakes for both corporates and investors are high. The challenge will multiply for financial institutions, which will need information on the financial consequences of ESG factors from individual companies and across asset classes and investment vehicles.

It is clear that governments take seriously their responsibility to act on climate change and other ESG issues. And the financial sector will have to respond to the requirements that will shortly be imposed on it. But above all, investors' demands are increasing. Information needs to come from the real economy: non-financial companies that manufacture, trade and deliver products and services.

From a company perspective, when interacting with the capital markets it is crucial to speak in the language of investors and lenders on ESG factors. What is the information need of the capital markets driven by risk-adjusted return expectations and sustainable finance regulation? Which are the company's key financial opportunities and risks, how are they managed and what is their expected financial relevance? Which business-integrated ESG targets have been set, why are they financially material and how is progress measured? How does governance, policies and board oversight ensure steady progress towards targets and what is the actual outcome? New reporting guidance and requirements support disclosing this information that a sustainable capital market needs.

Not acting positively and constructively on existing or upcoming non-financial reporting requirements could have a number of negative consequences:

- More difficult access to capital
- Lower stock valuation due to increased risk profile because of insufficient information
- Measures related to non-compliance
- Worse financial performance due to untimely action on the business risks and opportunities following from climate change

The time to act is now: to consider the strategic consequences from climate change and other financially-material ESG factors; to build systems and processes to meet current and upcoming regulatory and investor requirements; and to disclose ESG impacts and risks in mainstream reporting.

TCFD Status Report 2019

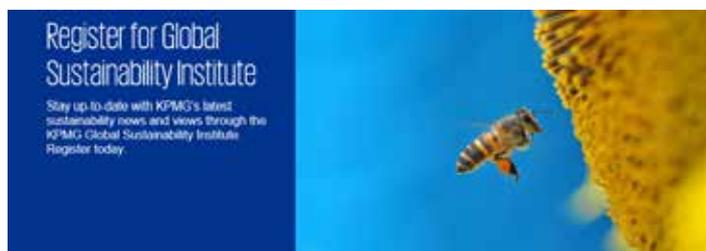
The TCFD's status report notes that the large-scale and complex nature of climate change makes it uniquely challenging, especially in the context of economic decision-making. It makes a number of challenging statements to corporates, including:

"...many companies incorrectly view the implications of climate change to be relevant only in the long term and, therefore, not necessarily relevant to decisions made today."

"Now more than ever it is critical for companies to consider the impact of climate change and associated mitigation and adaptation efforts on their strategies and operations and disclose related material information."

"...investors need better information on how companies – across a wide range of sectors – have prepared or are preparing for a lower-carbon economy; and those companies that meet this need may have a competitive advantage over others."

Further insights



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The numbers that are changing the world

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This booklet presents the proof to address the issues around responsible investment implementation: statistics from across investment markets that show how significant this shift is. Read it now to explore what's driving the trend.



The ESG journey: Lessons from the boardroom and C-suite

To build on our work in ESG, strategy and the long view, the Board Leadership Center interviewed directors and officers of major corporations, including Morgan Stanley, Tyson Foods, Ford Motor, Microsoft, Mars, and Whirlpool, among others.

Abbreviations

AMF	Autorité des Marchés Financiers, France	MiFID II	Markets in Financial Instruments Directive, revised, EU
CRA	Credit Rating Agency	OECD	Organisation for Economic Co-operation and Development
CTB	Climate Transition Benchmark, EU	PAB	Paris-aligned Benchmark
EIOPA	European Insurance and Occupational Pensions Authority	SFC	Securities and Futures Commission, Hong Kong (SAR), China
ESG	Environmental, social and governance	SR	Sustainability risk
ESMA	European Securities and Markets Authority	SWF	Sovereign wealth fund
FSB	Financial Stability Board	TCFD	Task Force on Climate-related Financial Disclosures
HLEG	High-Level Expert Group, EU	TEG	Technical Expert Group, EU
IASB	International Accounting Standards Board	UCITS	Undertaking for the Collective Investment in Transferable Securities
IDD	Insurance Distribution Directive, EU		
IFRS	International Financial Reporting Standards		

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