

# ESG: Fast-emerging challenges for financial institutions

A 2021 special report by Thomson Reuters Regulatory Intelligence



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## INTRODUCTION

Environmental, social and governance (ESG) issues have become a strategic priority for many corporate executives and boards. Virtually every industry is affected by the collective efforts of governments to tackle climate change, the effects of which have become all too stark in 2021. The recent scientific report from the United Nations further underscores the limited options that nations and organizations face in forestalling future catastrophes, with the Secretary-General calling the study a “code red” for humanity.

Financial services have a critical role to play. As capital providers to industry and channels for investing individual wealth, financial services firms are heavily involved managing the transition from a fossil fuel-dominated economy to one supported by renewable energy.

Given this responsibility, financial authorities across the world have made it clear that a broad range of issues including climate change, human rights and human diversity need to be managed alongside other more traditional risks.

For investment management and brokerage firms, international and regional financial authorities have proposed common standards and metrics for sustainability-related disclosure rules to help investors understand the opportunities and risks of ESG investing. Such disclosure requirements come as ESG-related investments have exploded. Sustainable investments in 2020 reached an estimated \$35.3 trillion, or more than one-third of all assets under management, in five of the world’s biggest markets.

Investment managers, banks, securities firms and their regulators face a difficult task. The risks associated with ESG issues are new and hard to quantify. For example, climate risk is unlike other financial risks. Its uniqueness and complexity, and the long-term nature of the risks, make quantifying the threat one of the biggest hurdles that regulators must overcome in developing new rules and regulations.

*Virtually every industry is affected by the collective efforts of governments to tackle climate change.*

Some financial authorities, such as those in the UK and the European Union, have made good progress toward requiring banks and insurance firms to report how they are managing climate risk. In the United States, where regulators got off to a slow start, work is gathering pace to create rules and requirements on disclosure and incorporating the effects of climate change into risk management frameworks.

In Asia, the picture is mixed. Some countries, such as Singapore and the Philippines, have incorporated environmental risk into their supervisory expectations for banks’ risk management systems. Others are still struggling, given the lack of data standardization, collection and disclosure rules.

At the international level, there is recognition among regulators that continuing dialogue, collaboration and agreement on standards and metrics are critical. Financial institutions and the industries they support will not be served by conflicting rules on climate risk, particularly for firms operating across jurisdictions.

To address such concerns, the International Organization of Securities Commissions (IOSCO) recently published a report on issuers’ sustainability-related disclosures. The report, developed by IOSCO’s Sustainable Finance Taskforce, reiterates the urgent need to improve the consistency, comparability and reliability of sustainability reporting for investors.

Meanwhile, the Network for Greening the Financial System (NGFS) is a collaboration among the world’s central banks to manage the risks associated with climate change. The network recently announced the creation of the Climate Training Alliance (CTA), bringing together authorities at the forefront of climate risk management, including banking and insurance supervisors, to share best practices for integrating these risks into their activities.

There is an understandable sense of urgency about climate risk, but financial institutions are also being forced to address social problems — whether employee diversity and inclusion, gender discrimination and burdensome working conditions, or larger issues such as income gaps and social inequality, particularly among poorer communities.

A more fundamental debate is brewing in the background concerning the “purpose” of companies; whether they should dispense with the long-held model of maximizing shareholder value and adopt a broader, more inclusive “stakeholder” strategy, with employees, communities and other constituents factored into company decision-making processes.

How financial firms manage their post-pandemic “back-to-work” policies, for example, is just one example of the reality facing executives and boards, and regulators are taking notice. Authorities in the UK and the United States have announced they are considering new diversity and inclusion rules.

From an international policy perspective regulatory harmonization remains elusive, complicating the task for financial firms. On the most pressing concern, climate change, there is continued disagreement at the highest levels of government. A recent gathering of energy and environment ministers from the Group of 20 (G20) nations failed to agree on the wording of climate change commitments in their final communiqué.

The G20 meeting was viewed as a critical step ahead of the 26th U.N. Climate Change Conference of the Parties, known as COP26, which will be hosted by the UK in Glasgow between October 31 and November 12. The G20 failure to agree common language before the Glasgow summit is likely to be seen as a setback to hopes of securing a meaningful accord in Scotland.

### ***Governance critical in navigating climate risks and social issues***

Governance is often an afterthought when discussing ESG issues. Yet, given the complex nature of the issues facing boards and management, effective governance and oversight is imperative and may be the most critical element.

The lack of international policy harmonization means firms may well face a regulatory patchwork of climate policies and requirements. Each jurisdiction is also likely to approach questions on diversity, inclusion and employee engagement in different ways.

Firms’ effectiveness at navigating divergent rules and regulations will be very much influenced by the strength of their governance, compliance, human resources and risk management processes. The challenge for boards is to ensure their firms have the right people and skills to provide oversight of these new risks. Boards may wish to assess whether they themselves have the right levels of skills and experience.

This report, which surveys emerging policies and regulations among the G20, seeks to provide financial firms with guidance on what they can be doing now to prepare for these regulatory challenges. Some organizations are further along than others. Banks, asset managers and insurers might wish to ask the following questions:

- How do we bring a comprehensive approach to ESG issues, embedding these new risks within our existing enterprise risk-frameworks?
- What are the roles and responsibilities for compliance, human resources and risk management, and do we have the right levels of talent and skill sets?
- How can we as an organization identify among our customers those who have the greatest exposure to climate change, and work with them to mitigate such risks?

It is impossible to have all the answers for dealing with a fluid regulatory environment — much less identify all the important questions — but the hope is that this report will provide financial organizations with a greater degree of clarity about what is at stake and what actions they should be considering.



Singapore and the Philippines, have incorporated environmental risk into their supervisory expectations for banks' risk management systems.

## MANAGING CLIMATE RISK: AN IMPORTANT ROLE FOR BANKS

When one looks across financial services different actors play varying roles when it comes to environmental issues. As intermediaries and providers of credit to industry, banks have a pivotal role in managing the transition from a fossil fuel propelled economy to one that is underpinned by renewable energy. This transition, or transition risk as it is often called, is one of the challenges that banks and their regulators face as economies seek to reduce carbon dioxide emissions, which make up the bulk of greenhouse gas (GHG) emissions.

The period of transition is largely speculative. It is affected by debate among governments and scientists and affected by changes in government policies, technological developments, or investor and consumer sentiment. With recent events and analysis suggesting that the window for managing this risk is getting smaller, transition risk is taking on immense importance.

A second, related, risk facing banks is physical risk, or the economic costs and financial losses resulting from the increasing severity and frequency of physical climate events, such as hurricanes, flooding or wildfires. The greater frequency of such events can reduce a borrower's ability to repay and service debt or a bank's ability to fully recover the value of a loan in the event of default.

Banks' exposure to physical and transition risks will also vary, depending on their customer base and the exposure their clients have to climate-related risks. These risks are also influenced by geography, economic conditions and government policies.

How climate risks translate into credit, market and liquidity risk for banks is an area of growing focus for regulators, with some arguing that much more research and work is needed.

### **Scenario analysis and stress testing**

Quantifying climate risks, whether transitional or physical, is a complex exercise and unlike the process used to evaluate traditional financial risks. As a result, banks and regulators are increasingly turning to scenario analysis as a tool to measure the financial impact of environmental change.

At some large banks, scenarios are being developed to incorporate future events such as a worldwide tax on carbon emissions, a policy decision that some argue is necessary to accelerate the transition to a low-carbon economy.

The implications of a carbon tax on a bank's customers and credit portfolio could be considerable, depending on the nature of its business and carbon emissions. In the case of oil and gas companies, for example, a carbon tax would increase production costs, likely reduce profit margins and increase prices for consumers, all of which could affect a bank's outstanding loans to such companies. The probability of default and the implications for credit rating of a global carbon price, however, will vary significantly across companies.

Those with higher operating margins, lower leverage and higher cash balances would be in a stronger position to absorb the shock and higher operating expenses. Regional differences in production costs could also affect a company's resilience.

Central banks and supervisors are also using scenario analysis techniques to assess transitional and physical risk factors. Much of the work is being led by the Network for Greening the Financial System, a group of more than 60 central banks, and by the Financial Stability Board's Task Force on Climate-Related Financial Disclosures (TCFD). For example, the NGFS has published its methodology and analysis for three scenarios: Orderly Transition, Disorderly Transition and Hot House World.

European central banks, such as the De Nederlandsche Bank (DNB), the Dutch national bank, have also applied scenario analysis in their stress-testing exercises. The DNB's work looked at the system-wide implications of four specific shocks:

- **Technology shock:** The share of renewable energy in the energy mix doubles, due to a technological breakthrough.
- **Double shock:** The carbon price rises globally by \$100 per ton, due to additional policy measures, while the share of renewable energy in the energy mix doubles, due to a technological breakthrough.
- **Confidence shock:** Corporations and households postpone investments and consumption, due to uncertainty about policy measures and technology.
- **Policy shock:** The carbon price rises globally by \$100 per ton, due to additional policy measures.

According to the Dutch regulator, the stress test results suggest that financial institutions can mitigate their vulnerability to a disruptive energy transition by including energy transition risks in their risk management. As a first step, institutions could map their exposures to industries that are most vulnerable to a disruptive energy transition. They could also conduct their own transition risk stress test to gain a sense of their vulnerability.

“By taking the energy transition into account in their exposures, financial institutions can mitigate the impact of transition risks on their institution and the financial system as a whole,” the DNB said.

“In addition, by explicitly accounting for energy transition risks, financial institutions may alter their investment decisions in a way that contributes to a timely energy transition and thereby decreases the probability of a disruptive scenario.”

Meanwhile, in June 2021, the Bank of England published its Climate Biennial Exploratory Scenario (CBES). The central bank said it “will explore the resilience of the UK financial system to the physical and transition risks associated with different climate pathways”.

The CBES uses three scenarios — early, late and no additional action — to explore the physical and transitions risks from climate change. The central bank expects to publish aggregated CBES results in May 2022. These first results will not call out laggards, but UK regulators have been clear for some time that they expect action to assess and mitigate climate risks on banks’ balance sheets.

Some central bank regulatory bodies argue that the use of scenario analysis in a bank’s stress testing exercise “will bring strategic implications related to climate change to the attention of senior management and the board of directors”.

The results, said a report by the central bankers’ Financial Stability Institute, might even lead to “reviewing exposures and possibly reducing them with regards to certain sectors or geographical areas.

“They could also lead to exiting certain activities altogether if the climate-related risks involved are deemed to be too high, or impossible to assess with sufficient accuracy or to mitigate adequately.”

At the same time, however, there is recognition that much more work is needed to evaluate the benefits of scenario analysis and its value in determining a bank’s exposure to climate risks. This is particularly the case when looking across countries, given the lack of common practices and standards for climate risk stress testing.

### **Capital requirements**

Looming in the background is debate about whether banks should eventually hold additional capital against future climate risk. Those who argue that capital requirements for climate risk should come sooner point to a scenario where the transition toward a carbon-neutral economy happens quickly and leads to large losses for banks exposed to high-risk sectors.

*ESG is a cultural undertaking  
for financial services firms.*

Others minimize such concerns, pointing to the high level of capital banks already have on hand to withstand any future transitional difficulties. Moreover, they argue that the complex nature of measuring climate risk and lack of substantive data available should give pause to regulators contemplating new capital requirements.

Regulators appear to recognize that higher capital will be required once everyone gets a better handle on how to measure climate risk. Sarah Breeden, executive director for UK deposit takers supervision at the Bank of England, has said she would “not rule out that capital is part of the solution” in the long term.

“Capital needs to reflect risk ... as we get a better understanding of that risk, we can get a better sense of whether capital currently reflects those risks,” Breeden said.

Among U.S. regulators, Michael Hsu, acting head of the Comptroller of the Currency, believes that regulatory capital requirements will eventually become part of the risk management equation.

“It would be hard for it not to be, because exposure is exposure and you have to risk-manage and capitalize for that,” Hsu said.

### ***Environmental crime and money laundering***

Given the pivotal role banks play in the fight against illicit finance, a new risk they face is the link between environmental crime and money laundering. The international anti-money laundering standard setter, the Financial Action Task Force (FATF), released a detailed report in July 2021 on this topic.

Environmental crime covers a wide range of activities, from illegal extraction and trade of forestry and minerals to illegal land clearance and waste trafficking. Actors involved in these crimes vary from large, organized crime groups to multinational companies and individuals.

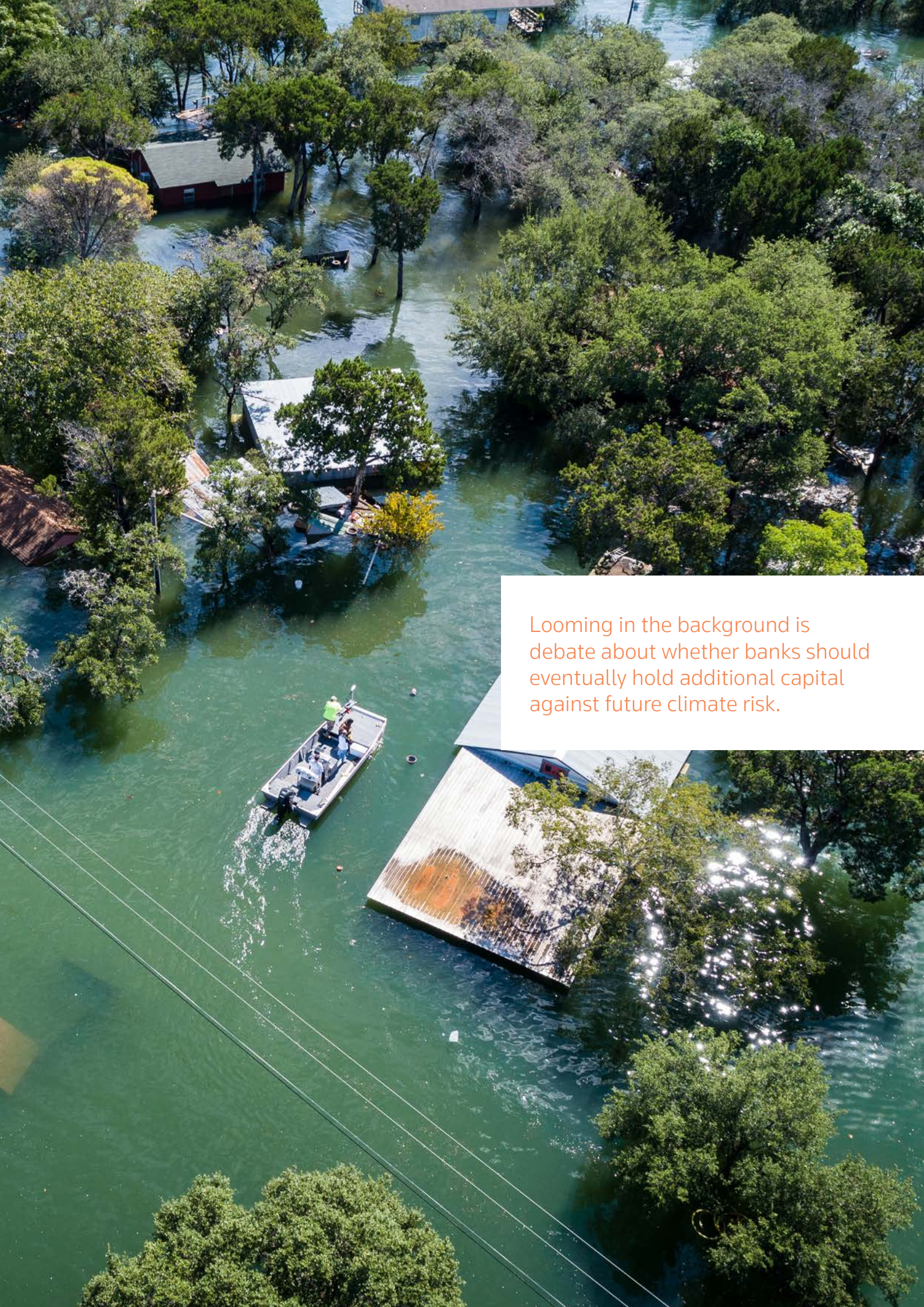
Perpetrators of environmental crime rely on both the financial and non-financial sectors to launder their proceeds. The “low-risk, high-reward” nature of environmental crime makes for a lucrative and safe source of revenue for criminals. This is partly due to a regulatory and legal environment that is not always consistent internationally and fails fully to address the financial aspects and money laundering risks of these crimes.

According to FATF, of all environmental crimes, forestry crime (including illegal logging and land clearing) seems to be the most significant by value of criminal gains. Interpol’s 2018 World Atlas of Illicit Flows found that forestry crime generates an estimated \$51 billion to \$152 billion annually.

FATF issued a series of standards to help the industry combat environmental crime, including:

- Criminalize money laundering for a range of environmental offences.
- Identify and assess money laundering and terrorist financing risks across crime areas, and take steps to mitigate these risks.
- Ensure the private sector is aware of money laundering and terrorist financing risks, and that it introduces preventative measures, such as reporting suspicious financial transactions. Of relevance for this report, these obligations extend to, among others: banks, dealers in precious metals and stones, lawyers and trust and company service providers when carrying out financial transactions.
- From a law enforcement perspective, countries should have sufficient powers to investigate, trace and confiscate criminal assets across crime areas.





Looming in the background is debate about whether banks should eventually hold additional capital against future climate risk.

## SUSTAINABLE FINANCE: EXPLOSIVE GROWTH REQUIRES GREATER DISCLOSURE

While banks have a critical role in managing the transition to a low-carbon economy, asset managers, securities firms and investment advisers are providing investors with products that allow them to invest in ESG opportunities.

Amid the global explosion in ESG investments, in the United States alone about \$17.1 trillion — roughly one-third of all assets under management — was being managed using some type of sustainable investment strategy, according to data for 2020 from the U.S. SIF Foundation, a sustainable-investing trade group. This represented a 42% increase from two years earlier, the group said.

Sustainable finance is also at the top of the G20's agenda. In April 2021, the Italian G20 presidency re-established the Sustainable Finance Study Group (SFSG) within the G20 Finance track and agreed to elevate it to a working group.

"This group will be central for coordinating international efforts to mobilize sustainable finance, which is crucial to achieve a global green and sustainable recovery. The working group will make it possible to develop a long-term G20 agenda that can help to drive the policy change needed to further align the financial system to the Paris Agreement and SDGs," Marcello Ranucci, a representative from Italy's Ministry of Economy and Finance, said about the upgrade.

There are various definitions of, and approaches to, so-called sustainable investing. Some strategies seek to avoid investments in industries deemed harmful to society such as tobacco, while others aim to further environmental or social causes such as climate change or workplace diversity. Regardless of the approach, interest in the category is growing dramatically.

Sustainable investing is relatively new, however, and international regulators have concerns over whether investors, particularly smaller retail investors, understand what they are buying and whether the firms offering such investments are providing adequate disclosure.

To that end, numerous regulators across jurisdictions have either put forward new rules on disclosure or are creating new requirements as concerns grow about fraudulent activities by companies and investment firms.

### **"Greenwashing"**

A major concern among regulators is "greenwashing", or the marketing of products as environmentally sound when in fact they are not. In the EU, many of the ESG measures being developed are designed to prevent greenwashing but it remains a concern.

In January 2021, the results of a website screening exercise conducted by the European Commission and national consumer authorities reported they "had reason to believe that in 42% of cases the claims were exaggerated, false or deceptive and could potentially qualify as unfair commercial practices under EU rules". The "sweep" analysed green online claims from various business sectors such as garments, cosmetics and household equipment.

To further highlight the problem, in July 2021 the UK Financial Conduct Authority issued a "Dear CEO" letter to chairs of authorized fund managers setting out expectations for the design, delivery and disclosure of ESG and sustainable investment funds.

"We have seen numerous applications for authorization of investment funds with an ESG or sustainability focus. A number of these have been poorly drafted and have fallen below our expectations. They often contain claims that do not bear scrutiny," it said.

In the United States, environmental activists have taken a more creative approach to targeting companies believed to be engaged in greenwashing. Large oil and gas companies, which increasingly tout their green credentials, have come under fire from activists who say such claims are misleading.

While several U.S. states and cities have sued fossil-fuel firms for alleged greenwashing in recent years, three environmental groups took a different tack in earlier this year when they launched a landmark complaint against Chevron Corp.

Rather than going through the courts, the green groups — Global Witness, Greenpeace and Earthworks — filed a false advertising complaint against Chevron with the Federal Trade Commission, which enforces rules against deceptive advertisements.

The three organizations are hopeful that their complaint to the national agency under the administration of President Joe Biden will gain more traction than a lawsuit filed in a federal or state court and will lay down a marker for further action against greenwashing.

### **Regulators advance new disclosure rules**

As with most ESG issues, the EU is ahead of other jurisdictions on implementing new disclosure rules. In March 2021, the Sustainable Finance Disclosure Regulation (SFDR) took effect. The regulation is complex but has one overriding purpose: to avoid the greenwashing of financial products and advice in the EU by providing more sustainability-related information. The SFDR aims to ensure that EU investors have the disclosures they need to make investment choices in line with their sustainability goals.

Through the disclosure requirements the sustainable finance regulation requires firms to make strategic decisions about their approach to sustainability. At its core, the regulation introduces the concept of principal adverse impacts (PAIs), which are the negative effects on sustainability factors that an investment decision or advice might have. Sustainability factors are listed as environmental, social and employee matters, as well as matters relating to human rights, anti-corruption and anti-bribery.

*Forward-thinking firms can use the compliance function, and their relationship with regulators, to influence future regulations on ESG.*

The SFDR requires firms to undertake a series of disclosures:

- Information on how an entity integrates sustainability risks in its investment decision-making process or financial advice.
- A statement on policies setting out how an entity considers PAIs on sustainability factors.
- Information on how remuneration policies are consistent with the integration of sustainability risks.
- Pre-contractual disclosures on sustainability risk integration, including assessments of how the performance of financial products may be affected by those risks.

The SFDR also requires firms to make product-level disclosures, depending on the objective of a given product:

- For firms that consider PAIs, an explanation of how financial products account for these impacts should be provided. This applies to all the firm's products, whether they are intended to meet sustainability goals or not.
- For "art 8" (Article 8) products that promote "environmental" or "social" characteristics, there must be additional information on how these are met, including disclosure about the degree of taxonomy alignment of underlying economic activities.

- For “art 9” (Article 9) products that have sustainable investment as an objective, there must be an explanation of how the objective is achieved as well as additional disclosure on alignment with the EU Taxonomy Regulation.

### ***Singapore authorities lead the way in Asia***

The EU’s approach may be the most advanced and complex, but other regions are also making progress toward enhanced disclosure. In Asia, Singapore-listed firms have shown an overall improvement in the level of sustainability disclosures in their latest sustainability review reports, according to Loh Boon Chye, chief executive of the Singapore Exchange.

Almost half the issuers have already discussed climate change as an economic, environmental, social and governance factor in their sustainability reports, and about one-third of issuers said it is a material topic for them. Issuers of smaller market capitalization posted the largest increase in average scores of sustainability disclosures, he said.

The Green Finance Industry Taskforce under the Monetary Authority of Singapore (MAS) recently released an implementation guide to climate-related disclosure measures by financial companies, together with a framework that assesses eligible green trade-finance transactions.

The disclosure guide sets out best practices aligned with recommendations of the international Task Force on Climate-Related Financial Disclosures.

“[It] outlines specific disclosure practices for each of the banking, insurance and asset management sectors, taking into consideration the different approaches that individual sectors could take,” MAS said. The guide will facilitate more consistent and comparable disclosures across financial companies.

### ***SEC prepares to battle U.S. companies on climate disclosure***

In the United States, new disclosure rules for ESG investments have become a heated topic among companies, with the Securities and Exchange Commission (SEC) preparing to launch new regulations on climate disclosure in the coming year.

In advance of a final rule proposal, the SEC has been deluged with contributions from the public on new climate disclosure rules, with commentary coming from academics to political figures, individual companies to investors and trade organizations to environmental advocates. Some of the biggest concerns focus on the agency’s authority to mandate new disclosure rules, international standardization of future regulation and whether there should be an emphasis on quantitative versus qualitative information.

According to an analysis by the law firm Davis Polk, the SEC’s request for public input on climate disclosures, which was announced in March, attracted 297 institutional comments totaling 3,290 pages, underscoring widespread interest in future climate regulation. With the public comment window now closed, the law firm has analyzed the resulting feedback, which it found to be “both important and representative of differing stakeholder views”, in anticipation of a formal SEC proposal expected around October 2021.

Apart from questions regarding the SEC’s authority and role, there were also legal comments about potential securities-law liability considerations. Other comments concerned external and internal oversight of disclosures, and whether the SEC’s coming rulemaking should be limited to public issuers, or should also include private issuers.

### **Summary of major issues, concerns**

In sifting through the mountain of commentary, Davis Polk listed several questions from respondents that it felt were most salient. These include:

- Does the SEC have authority to mandate climate disclosures, and would doing so survive the cost-benefit analysis required for rulemaking?
- Given a perceived desire for both meaningful and comparable climate disclosures, which types of disclosure standards (for example, general or industry-specific standards, a single standard or multiple standards worldwide and a standard drawing on existing third-party frameworks or a novel framework) should the SEC use for any mandatory climate disclosure regime?
- If the SEC mandates climate disclosures, what information should the regulator require to be disclosed?
- Should the SEC provide protection from liability, whether through a safe harbor, requiring climate disclosures to be furnished rather than filed, or by requiring disclosures on a specialized form outside of 10-Ks and 10-Qs?
- Should climate disclosures be subject to the same level of rigor as other types of SEC disclosures, such as financial disclosures, by imposing requirements for audit or assurance or internal controls?
- If the SEC creates a new disclosure mandate, should its scope include both public companies and private companies and not only climate disclosures but also ESG disclosures more broadly?

As seen in the questions raised about the SEC's efforts, achieving greater disclosure for investors in ESG products can be an arduous journey. Much recent focus has been on climate-related products, but regulators are also seeking more information on the "social" aspect of ESG, whether it concerns diversity, inclusion, remuneration, employee turnover or broader efforts to support lower- and middle-income communities.



## SOCIAL ISSUES: HUMAN CAPITAL LIES AT THE CENTER OF THE DEBATE

If regulators are finding it challenging to achieve greater transparency and disclosure in the continued rapid growth of ESG investments, they are likely to encounter some of the biggest hurdles when asking companies to divulge more information about human capital: their employees.

The “S” part of ESG can refer to many things, but if there is a common thread that runs through diversity, inequality, inclusiveness, remuneration, turnover as well as workplace health and safety, it is the employee as a critical stakeholder.

### **Human capital management: what do regulators want and what are companies reluctant to share?**

In most of the G20 nations, companies are required to divulge very little information about their employees. There are exceptions, and again, the EU is more advanced in requiring firms to provide data on ESG, or non-financial data, to use the EU’s own term.

The EU Non-Financial Reporting (NFR) Directive mandates large, listed EU companies and financial corporations to disclose information on environmental, social, human rights and anti-corruption matters.

More specifically, companies falling under the scope of the NFR Directive are requested to disclose information on:

- Environmental matters.
- Social matters and treatment of employees.
- Respect for human rights.
- Anti-corruption and bribery.
- Diversity on company boards (in terms of age, gender, educational and professional background).

The directive, according to some critics, fails to define which specific information and key performance indicators companies must disclose, or the specific matters they should address. Furthermore, the general reporting requirements listed in the directive allow contradicting interpretations, which some say undermines the objective of the law to increase the consistency and comparability of sustainability information.

Responding to such perceived weaknesses, in April 2021 the European Commission adopted a proposal for a Corporate Sustainability Reporting Directive (CSRD), which would amend the existing reporting requirements of the non-financial reporting directive. That proposal would:

- Extend the scope to all large companies and all companies listed on regulated markets (except listed micro-enterprises).
- Require the audit (assurance) of reported information.
- Introduce more detailed reporting requirements, and a requirement to report according to mandatory EU sustainability reporting standards.
- Require companies to digitally “tag” the reported information, so it is machine-readable and feeds into the European single access point envisaged in the capital markets union action plan.

*There is growing awareness among younger employees that they have options, and that what was once seen as a glamorous job in finance may look less appealing.*

A similar story is playing out in the United States. Until recently, companies were required to disclose only staff headcount to financial regulators. Under former President Donald Trump's administration, however, the SEC last year introduced a rule requiring companies to disclose workforce information that they deem material.

That rule, effective since last November, has proved too vague and has failed to yield meaningful data, according to some studies.

Of 100 big company annual disclosures analyzed by Stanford Business School, for example, most adopted boilerplate language and only 43% provided quantitative metrics. Few provided data about problems that affect strategy and productivity, such as talent recruitment, training, retention and incentive systems, according to the May study.

Among the areas where companies were least inclined to offer information, pay diversity and employee turnover stood out.

The issue has become more urgent as the pandemic and social justice movements force companies to review working conditions, pay equity, hiring and retention policies. The Biden administration has elevated such issues in its policy agenda, and Gary Gensler, the SEC chairman, is preparing to ramp up corporate requirements on human capital management.

The SEC is likely to mandate specific human capital metrics. Gensler has said these could include workforce turnover, skills and development training, compensation, benefits, workforce demographics and health and safety.

With respect to demographic data, an increasingly important issue for investors, the metrics are likely to include race, gender, sexuality, age and physical ability, according to groups pushing for the changes and two sources with direct knowledge of the agency's thinking.

"We should think carefully about including a handful of common-sense, readily accessible metrics, especially in areas of significant consensus such as workforce diversity," Allison Lee, Democratic commissioner, told Reuters in a recent interview.

### ***Financial firms may need a rethink on employee policies***

The pressure for company reform is not only coming from regulators, however. Major financial exchanges are also jumping into the fray, with the SEC recently approving a proposal from Nasdaq that will require companies listed on the exchange to demonstrate they have diverse boards.

The listing rules would require companies to disclose diversity statistics for board directors, including one who identifies as female and one from an underrepresented minority or LGBTQ+, or explain why they do not. Companies also must publicly disclose the diversity of their boards.

Firms are also experiencing pressure internally from employees. Goldman Sachs recently decided to raise salaries for junior staff in response to complaints about burnout from new recruits caught in a deal-making boom during the pandemic. It is following the lead of other Wall Street firms responding to criticism of excessive working conditions.

Goldman analysts had circulated a slide deck detailing 95-hour weeks and workplace abuse, exacerbated by the isolation of homeworking during the pandemic. Their protest has put a sharper lens on big bank workplace conditions. Many large banks have since sent memos and published press releases committing to changing the way staff work.

Whether any meaningful change comes about remains to be seen but there is growing awareness among younger employees that they have options, and that what was once seen as a glamorous job in finance may look less appealing.





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## EARLY SIGNS OF REGULATORY COORDINATION ON CLIMATE REPORTING STANDARDS

Regulatory oversight of ESG issues has been fragmented, with different regions at different stages in terms of providing disclosure rules and guidance for firms.

A lack of common standards and taxonomies across regions is also evident, which conspires to make management of ESG issues more difficult, particularly for companies with an international footprint.

For example, although ESG is gathering momentum in Asia, it remains in relative infancy. Investors and analysts are waiting for an agreement on a reporting standard that could streamline the data collection process and produce more quality data to assess ESG advances in the financial markets.

Asia's major financial centers have all implemented ESG regulations, compliance and quality-disclosure measures to try to improve ESG reporting. Clearer standards and a more consistent approach to ESG integration are needed, however, to help Asian regulators, promoters and investors assess data more accurately.

There are signs from some regulators that change may be coming. The first corporate climate reporting standard is planned to take effect as early as mid-2022 following orchestrated efforts by the International Financial Reporting Standards (IFRS) Foundation and IOSCO, according to Ashley Alder, chief executive of the Securities and Futures Commission in Hong Kong.

The aim is to establish an international corporate sustainability reporting standard for financial services firms, following an agreement at the G7 summit held in the UK in June.

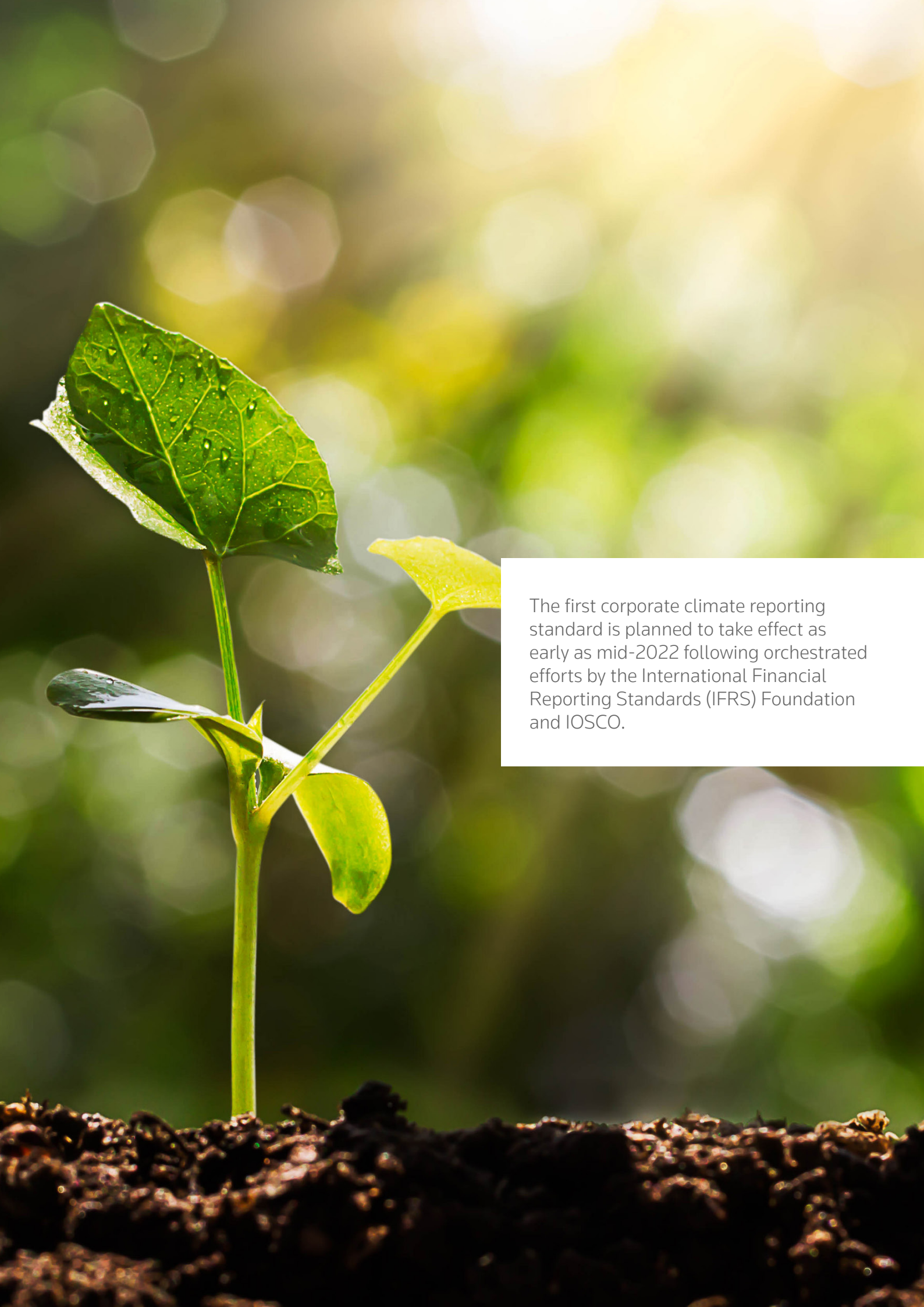
"The G7 was the latest organization to recognize the urgent need for a globally consistent corporate reporting standard for sustainability," Alder said.

The G7 communiqué explicitly supported the IFRS Foundation's move to establish a new Sustainability Standards Board to achieve this, Alder told a virtual conference, "City Week 2021: Financing A Sustainable Global Recovery". The June conference brought together industry leaders and policymakers to consider the future of international financial markets, and London in particular.

The new Sustainability Standards Board is expected to be set up by the COP26 summit due to take place in Glasgow this autumn. IOSCO, which is chaired by Alder, will work closely with the IFRS Foundation to develop the standard.

"This effort is essential to enable companies worldwide to clearly communicate how sustainability factors relate to their financials," Alder said.

The standard has been initiated by private-sector sustainability standard-setters — the Climate Disclosure Standards Board, the Global Reporting Initiative, the International Integrated Reporting Council, the Sustainability Accounting Standards Board and the Carbon Disclosure Project — together with the FSB's Task Force on Climate-Related Financial Disclosures.



The first corporate climate reporting standard is planned to take effect as early as mid-2022 following orchestrated efforts by the International Financial Reporting Standards (IFRS) Foundation and IOSCO.

## GOVERNANCE: ESG AS A STRATEGIC PRIORITY

ESG is a cultural undertaking for financial services firms. It would be impossible to achieve the sustainable finance objectives if firms failed to embed the necessary approach into the heart of their culture and strategy. This makes the “G”, or “governance”, component of ESG fundamental to the success of future gains on sustainable finance.

Governance is the part of ESG that makes the whole package hang together. Without attention to governance, the environmental and social elements are not achieved and the ESG initiative fails. ESG requirements need to be embedded in a firm’s strategy, culture, risk management and operational control arrangements such as data governance and third-party management.

### **Strategy, culture and policy**

Boards need to ensure that within their structure there is clear accountability for ESG-related matters. This is vital to embedding ESG in a firm’s culture. Communicating the right tone from the top is important when determining a firm’s ESG approach.

Boards need to promote a culture that is ESG-friendly and not only addresses the environmental benefits for the firm but also promotes a socially diverse environment. Corporate policies should be amended to reflect support for ESG-related issues, and these should be documented and communicated in a clear and understandable way that all staff can access, with appropriate training provided.

Firms should also consider the overall impact of ESG requirements on their strategy and culture. Areas such as the products they sell, the services they provide, the costs they incur through staff, premises and buildings, the supply chain and other items should all be reviewed from an ESG perspective. Firms will then be able to reach a conclusion about the profitability and ethical nature of current strategy and operations – what needs to change and how this should change.

### **Risk management**

ESG presents a unique challenge for risk management. The fundamentals – identify, assess, manage and report – of a firm’s risk management framework may not change but their application to ESG risks establishes a separate pillar of risk management.

Within risk taxonomies, ESG risks could be viewed as a separate umbrella category to sit alongside operational risks, credit risk and market risk. Owners of ESG risks will have to be designated, in line with the responsibilities allocated by boards and, where appropriate, by the senior management regime of each jurisdiction.

A firm should now include ESG in its risk appetite assessment and employ key risk indicators and guard rails that allow the board to assess compliance with the firm’s ESG risk appetite. Board risk committees should have their terms of reference amended to cover ESG risks, and skill sets within risk departments should be reviewed to ensure appropriate levels of knowledge and experience on ESG-related matters.

### **Compliance arrangements**

Compliance departments are vital controls in a firm’s approach to ESG. It is important that compliance officers have senior positions within a firm so they can contribute to, and influence, its future ESG strategy. A firm can use effective identification and assessment of upcoming ESG regulations and best practices to shape this strategy, and forward-thinking firms can use the compliance function, and their relationship with regulators, to influence future regulations on ESG.

The compliance department itself needs sufficient skills, knowledge and experience of ESG matters to advise the firm appropriately. Training and competence schemes, personal development plans and recruitment strategies all need to be reviewed to determine whether the firm has adequate ESG compliance resource.

### **Whistleblowing**

In the United States, the SEC is actively soliciting individuals to notify it of greenwashing. EU-based firms should remember the cross-over and interlinking of ESG rules with whistleblowing requirements. The Markets in Financial Instruments Directive II (MiFID II) has a specific requirement for firms to establish and maintain a whistleblowing pathway for employees to speak up when they become aware of a breach of the legislation.

Given that MiFID II has, among other things, strict rules about identifying target markets and product recommendations, employees are required by the directive to speak up if they encounter greenwashing. The arrival of the EU whistleblowing directive in December will extend this obligation to speak up to all EU financial rules.

### **Remuneration**

The only way to end the “rhetoric/reality gap” on ESG is to firmly embed it in remuneration. That was the view of Lise Kingo, chief executive of U.N. Global Compact, in June 2020 as she came to the end of a five-year term leading the effort to get the private sector signed up to the U.N.’s sustainability agenda. At present the proportion of pay allocated to achieving ESG objectives is negligible. Despite lengthy climate and diversity sections in banks’ annual reports it remains far from transparent how delivering — or not — on these commitments is tied to the pay of C-suite executives and boards.

### **Data gaps and governance**

Regulators and industry agree there are significant ESG data gaps but have failed to agree an approach to closing them. Lawmakers, and regulators, have pressed on with requirements produce data as they believe that it is essential — even if just “best efforts” — to delivering ESG goals.

The plethora of voluntary data standards is not, however, helping regulators achieve their objectives. As previously described, work has begun at the IFRS Foundation on a new disclosure standard for climate risk. Akin to the IFRS accounting standard, the intention is that it would be adopted as the default climate risk standard by countries the world over.

Given the new data requirements outlined in the disclosure rules, firms are faced with challenges when obtaining, assessing and disclosing ESG data in the correct way. Firms may wish to assess the impact the new data requirements have on their data governance arrangements.

Particular challenges may include:

- **Cultural and operational issues** — there may be a lack of leadership, or a tendency to put the wrong person into a leadership position, that undermines the understanding, support and value of data governance. Budgets may be limited, with a reduced number of employees available to fill data roles. Historic documentation may be weak, further restricting a manager’s ability to bring about change.
- **Unexpected outcomes from legacy processing** — existing technology may restrict a firm’s ability to process data in the way it would wish in future. This may lead to both data and regulatory breaches.

- **Third-party services** — the sharing of customer data, security of data and retrieval of data. This may also pose concentration risk where a particular outsourced firm is used by several organizations, some of which may be competitors. Operational resilience, the ability of firms to recover from a business disruption, needs to be considered here — i.e., the ability of the outsourced firm to recover in line with the host firm.
- **Cyber resilience** — the security of data is a vital principle within the data governance framework. Data breaches and unauthorized disclosure of confidential information are on the rise. A firm must have confidence in any systems to protect the data they contain. As technology develops into a far wider range of applications than previously seen, this challenge becomes more difficult.

A framework should include the following:

- **Strategy** — make sure that data-use governance is aligned to business strategy and objectives to ensure the maximum possible opportunity for embedding within the firm.
- **People** — allocate clear and transparent accountability for responsibilities associated with data and decision-making surrounding data. Ensure the organizational structure and management roles is clear so the board has clear line of sight into data management within the firm. This could include the creation of a head of data role, responsibilities for the IT and business teams and the identification of an executive sponsor.
- **Policies and procedures** — these should address how the data is going to be used and the way risks are addressed. It may be useful to set minimum standards for data usage with clear key performance indicators and management information.
- **Monitoring and reporting** — the firm should have a risk-based methodology for monitoring the data policies and procedures to provide the board with assurance that data is being handled appropriately.
- **Governance arrangements** — outsourced and third-party arrangements need to be managed within a clear corporate governance structure. Risks need to be managed within a firm-wide risk management framework. Terms of reference of risk committees and operational risk committees, or their equivalents, need to include the responsibility for outsourced arrangements. Clear ownership needs to be apportioned to facilitate greater line of sight by the board into outsourced arrangements.



## APPENDIX: A round-up of ESG measures being taken or contemplated by members of the Group of 20 leading economies.

### **Argentina**

At the beginning of 2021, Argentina's capital markets regulator, the Comisión Nacional de Valores (CNV), launched a consultation for draft guidance on socially responsible investment which aims to promote the integration of ESG factors into decision-making. It has also proposed a regulation for sustainable collective investment products and a draft resolution on sustainable guidelines. All listed companies in Argentina are required to adopt Corporate Governance Code (Código de Gobierno Societario) issued by CNV and implemented on a "comply-or-explain" basis.

### **Australia**

At the Commonwealth level, Australia has a range of regulations and laws relevant to ESG, including modern slavery and gender equality protections. Regulatory guidance relating to the Corporations Act 2001, the principal legislation applying to companies, requires a company to disclose whether it is facing ESG risks which could affect its financial performance or other material issues. For listed companies, the ASX Corporate Governance Council Principles and Recommendations include the recommendation that "a listed entity should disclose whether it has any material exposure to environmental or social risks, and if it does, how it manages or intends to manage those risks".

### **Brazil**

The Central Bank of Brazil, which is independent of the government, has proposed legislation which would require banks to disclose more information relating to social, environmental and climate change-related risks. The central bank is also proposing new rules regarding environmental, social and rural loans which would prohibit lending to projects in indigenous or deforested land. Jair Bolsonaro, the president of Brazil, has committed to ending illegal logging in the Amazon by 2030, but concerns remain about deforestation.

### **Canada**

While corporate and securities laws do not explicitly regulate corporate social responsibility, under the Canada Business Corporations Act corporate directors must act with a view to the best interests of a company. This includes considering factors such as the environment and employees. Reporting issuers in Canada are required to disclose material risks, which may include a broad range of environmental matters, such as climate change. Under corporate governance requirements Canadian firms are required to adopt a written code of business conduct and ethics applying to both employees and the board.

### **China**

China, which is the planet's biggest polluter, has committed to reaching peak carbon emissions by 2030 and net zero emission by 2060. In May 2021, the China Securities Regulatory Commission launched a consultation on revised disclosure rules for listed companies including the addition of environmental and social responsibility requirements. Among other things, firms are encouraged to voluntarily disclose what actions they have taken to reduce carbon emissions, alleviate poverty and regenerate rural areas.



## **France**

Under a French law adopted in 2017, firms are subject to a corporate duty of vigilance. The law only applies to the largest French companies. It requires them to identify and prevent risks to human rights and the environment that could occur because of their business activities. In July 2019, France's twin regulators created a framework to monitor and evaluate climate-related commitments made by banks, insurers, and asset managers. In their first annual report looking at these, the two regulators noted that more than 300 individual or collective commitments had been made.

## **Germany**

In late 2019 the German financial regulator, BaFin, issued non-binding guidance for firms on dealing with sustainability risks, which it defined based on ESG criteria. BaFin said it was important for firms to focus more strongly on all ESG risks and that they should either develop an independent strategy for dealing with such risks or adapt existing strategies to them.

## **India**

The Indian government has sought to define responsible business conduct via national guidelines built around nine principles. The principles cover a range of issues including sustainability, ethical behavior, environmental safety and labor practices. In early May 2021, India's Securities and Exchange Board introduced new ESG obligations and reporting requirements on the top 1,000 listed companies by market capitalization. As well as incorporating ESG risks into governance procedures, affected firms are required to include in their disclosures a business responsibility and sustainability report setting out the initiatives they have taken from an ESG perspective.

## **Indonesia**

Indonesia's Financial Services Authority in 2017 introduced regulations on the application to financial institutions of sustainable finance, defined as supporting the creation of sustainable economic growth by harmonizing economic, social and environmental interests. As well as requiring firms to produce and implement a sustainable finance action plan, the regulations include ESG reporting requirements.

## **Italy**

The Italian legal framework includes several ESG-related provisions including laws relating to environmental liability, liability for pollution damage, and on green procurement. It has also incorporated EU-based requirements such as the Shareholder Rights Directive and the Corporate Sustainability Reporting Directive. Trade bodies representing the various financial sectors have also signed up to a charter of sustainable and responsible investment of Italian finance containing three ESG-related principles.

## **Japan**

Among Japanese efforts in developing its ESG regulations has been the creation of guidelines for companies by the Ministry of Economy, Trade and Industry that require them to report on ESG performance. In 2020 the Tokyo Stock Exchange published requirements for ESG disclosure and more recently Japan's Financial Services Agency issued revised guidelines for investor and company engagement placing more attention on how a firm responds to sustainability and ESG issues and makes disclosures on these.

### **Republic of Korea**

At the beginning of 2021, Korea's Financial Services Commission unveiled several measures that are intended to improve ESG disclosures. This included the introduction of mandatory ESG disclosures for listed companies from 2030 and proposed changes to the Korean Stewardship Code aimed at strengthening fiduciary duties related to ESG issues.

### **Mexico**

Reporting on environmental and social issues is voluntary but Mexico's two main stock exchanges (Bolsa Mexicana de Valores and Bolsa Institucional de Valores) have both launched an ESG disclosure project aimed at improving the availability of ESG information. Bolsa Mexicana de Valores has also produced a sustainability guide providing guidance on integrating ESG factors into business operations and planning.

### **Russia**

In July 2021 Russia's central bank issued a letter to public companies recommending disclosures on how they consider ESG factors and incorporate them into their business model and development strategy. At this stage such disclosure is only being recommended, but the central bank has indicated that it could become mandatory later.

### **Saudi Arabia**

Under its Vision 2030 strategy, Saudi Arabia has set out the ambition of creating a more sustainable future. In July 2021, the kingdom's sovereign wealth fund was reported to have asked banks for help in developing an ESG framework.

### **South Africa**

South Africa already has several ESG-related regulations relating to the financial sector. A government technical paper on sustainability issued in 2020 recommended the development of guidance for use by the financial sector in identifying, monitoring and reporting and mitigating their environmental and social risks at portfolio and transaction level. Under the first principle of the Code for Responsible Investing in South Africa (issued in 2011 and which applies on a voluntary basis) institutional investors are already required to "incorporate sustainability considerations, including ESG issues, into their investment analysis and investment activities".

### **Turkey**

In October 2020, Turkey's Capital Markets Board amended its corporate governance communiqué to incorporate sustainability principles as part of the disclosure requirements for listed companies. The regulator has also issued a sustainability principles compliance framework which sets out sustainability principles to be followed by listed firms. Adherence with the principles is on a "comply-or-explain" basis.

### **United Kingdom**

The UK government is working toward making TCFD-aligned disclosures mandatory across the economy by 2025. Ahead of COP26, the government has committed to publishing a roadmap on the UK approach to requiring firms to disclose their risks and opportunities from, and impact on, the climate and the environment via integrated sustainability disclosures requirements. The UK's twin regulators have signalled a willingness to mandate some ESG issues and are considering the imposition of new diversity and inclusion requirements on firms.

**United States**

President Joe Biden has made climate change and ESG issues a priority for his administration. In March 2021, the SEC announced it had formed an ESG taskforce to look at gaps or misstatements in ESG disclosures as well as compliance issues relating to the ESG funds and financial advice. Other regulatory bodies including the Office of the Comptroller of the Currency (OCC) and the Federal Reserve have also emphasized various aspects of ESG, such as climate risk.

**European Union**

The European Commission has launched several ESG-related initiatives under its European Green Deal action plan including a review of the existing Non-Financial Reporting Directive. The Commission was an early mover in developing a taxonomy of sustainable activities and has sought to integrate sustainability issues into decision-making and disclosures by such legislative frameworks as the Sustainable Finance Disclosure Regulation.



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