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THE CORPORATE ESG GUIDE

THE ESG LANDSCAPE AND ECONOMIES IN TRANSITION

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THE CORPORATE ESG GUIDE

THE ESG LANDSCAPE AND ECONOMIES IN TRANSITION

By Dr Elena Zharikova & Andrew Archer of Investor Update — ESG Advisory

November 2021

COP26 has brought together the world's political leaders with power and asserted motivation to turn back the carbon clock from 'one minute to midnight'. The ESG Advisory Team of Investor Update has undertaken a comprehensive assessment of the way that the industrial world is transitioning towards low carbon intensity. More than 50 interviews of the leading and most influential ESG protagonists were conducted from five continents across the worlds of industry, regulation and finance. All major sectors are represented including Ford, Adobe, Tesco, Coca-Cola FEMSA, Enel, Orange, Sanofi, Gazprom, Goldman Sachs, Credit Suisse, SASB, TNFD, the FRC and the IMF. This has produced the most wide-ranging and complete view of the experiences, challenges and successes of these entities with the resources and the responsibility to deliver a just and sustainable transition.

The collective financial and cultural leverage that this group wields has the potential to accelerate economic transition to the decarbonised future the world needs. Their commitments, their ambitions and their frustrations frame and inform the findings of the paper, which also considers the growing focus on Social issues as companies and investors attempt to determine key measures and improvements across the workforce, communities and other stakeholders. In almost all aspects of this investigative research the collective spirit was willing, but the task remains daunting, beset by intrinsic and extrinsic inhibitors.

One notable conflict is the hardship that can be caused at a sub-societal level by sweeping climate-led initiatives that result in divestment and spin-outs of high-emitting assets. According to numerous participants, this introduces the risk of an 'Unjust Transition' and surrenders the stewardship of responsible investors. It has become clear that unilateral solutions can only go so far in rolling back the carbon-intensive years of the industrial age – only by understanding the collective challenge and response can real progress be made. The result is a Landmark Research White Paper on the ESG Landscape, focusing on Economies in Transition which frames the nature and urgency of the global threat presented, mirrored by the way industry is rising to meet that challenge and looking to prosper in the process.

Key White Paper Findings & Conclusions

→ There is a lack of clear transition pathways for some key sectors, which is deterring some corporates from setting specific climate targets. This, combined with a misalignment of incentives within corporate leadership, is creating a conflict between long-term climate considerations and short-term market pressures.

→ Investors face a similarly conflicted challenge in reconciling the implications of decarbonisation commitments and their duty to deliver investment returns.

→ The lack of common understanding around key ESG concepts is a persistent obstacle to their measurement and application in investment decision-making, compounded by ESG-linked investment products considering divergent aspects of ESG performance and data.

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DRIVING BEHAVIOURAL CHANGE

→ Engagement with corporates is widely championed as the preferred method to facilitate the transition towards more sustainable business models.

→ This is challenged by some who cite the slow pace of change and inconsistent priorities of investors and their clients, calling instead for more active and unified regulatory involvement.

→ Low levels of ESG data quality and consistency remain a significant hurdle to progress, and while information on carbon emissions is the exception, gaps and inconsistencies remain.

USE AND MISUSE OF ESG KPIS

→ Reporting on biodiversity and most social indicators is significantly lagging, drawing the criticism that companies are hiding behind the lack of universally measurable KPIs.

→ Most financial stakeholders observed a profound inconsistency in board-level sophistication around ESG with social and governance experience more prevalent than technical climate expertise.

→ The risk of isolating ESG discussions within the board can be countered by distributing ESG expertise and responsibilities throughout the governance structure and through to commercial operations.

→ Integration of ESG elements in executive remuneration are encouraged by all stakeholders despite the inconsistent approach, accuracy and integrity of policies, data and specific KPIs. Weightings currently vary from 10-50% of total variable compensation

RISING INVESTOR AUTONOMY ON ESG RESEARCH

→ Several investors maintain a relatively sceptical view of ESG ratings and ESG data providers, referring to the uncertainty around methodologies and the focus on company disclosure over ESG performance, which leads to bias against smaller companies and emerging jurisdictions.

→ An increasing proportion of Active Investors are developing sophisticated internal research teams and systems to appraise ESG performance to counter the inadequacies of 3rd party ratings.

→ This is giving rise to a proliferation of different ESG data products focusing on a diverse range of specific themes including climate, human rights, social, ESG risks, biodiversity and many more.

EVOLUTION OF STANDARDS & REGULATION

→ Supply chains and biodiversity information have been attracting increasing market and regulatory interest, specifically around land biodiversity management and invasive species. Attention will be focused by the upcoming biodiversity disclosure framework by the Taskforce on Nature-Related Financial Disclosures, currently in development.

→ Investors' opinions on the UN SDGs (Sustainable Development Goals) diverged significantly from 'useful' to criticism over their broad nature and a need for more outcome-focused disclosures.

→ All frameworks are valued to differing degrees with TCFD garnering the most specific support, coupled with a universal desire for a common ESG disclosure framework, achieved over time.

→ The current focus on improving reporting can displace or obscure meaningful strategic action — improved ESG data quality will not see sufficient capital reallocated towards sustainable companies if investors' primary goals remain the pursuit of premium investment returns.

→ The importance of the collective industry initiatives such as Climate Action 100+ was extensively referenced in driving change in corporate behaviour.

→ Despite conceptual and directional support, the EU Taxonomy drew criticism for its environmental focus and definitional problems, and similar criticisms were aimed at the SFDR for its excessive restrictive definitions that are slowing the flow of capital to companies that require funding for their transition efforts.

ESG AS A DRIVER OF COST OF CAPITAL

→ A rise in the cost of capital for companies that fall short of investors' expectations around ESG is now widely observed with the reverse equally evident and prominent in equity and bond valuations.

→ A group of stakeholders highlighted that this superficially efficient market outcome is in fact proving counter-productive by marginalising companies with credible transition strategies and meaningful emission reduction commitments that require investor support in order to execute those plans

→ More positively, corporates that can demonstrate a differentiated ESG performance are benefitting from increased capital sponsorship, accelerating the transition to a decarbonised industrial world.

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Interviewees

Akber Khan	Senior Director	Al Rayan Investment
Alberto Carrillo Pineda	Co-Founder and Managing Director of the SBTi	Science-Based Targets
Alex Bernhardt	Global Head of Sustainability Research	BNP Paribas
Andrew Lee	Managing Director, Head of Sustainable and Impact Investing	UBS Wealth Management
Antonio Celeste	Head of ESG Product at Lyxor ETF	Lyxor
Bridget Fawcett	Global Head, Strategy and Co-Head, Sustainability and Corporate Transitions, Banking, Capital Markets and Advisory	Citi
Bryan Esterly	Director of Research	SASB
Carolina San Martin	Managing Director, Director of ESG Research	Wellington Management International
Casey Dwyer	Portfolio Management	Andurand
Chris Griffith	Group Investor Relations & Corporate Development Director	Tesco
Claire Dorrian	Head of Sustainable Finance, Capital Markets at LSEG	LSEG
Cornette van Zyl	Investment Analyst and Associate Portfolio Manager	ABSA Group
David Craig	TNFD Co-Chair	TNFD
David Curran	Co-Chair of the Sustainability and ESG Advisory Practice and Executive Director of the ESG and Law Institute	Paul Weiss
David Harris	Global Head of Sustainable Finance, Data and Analytics at LSEG	LSEG
Deb Wasser	Vice President, Investor Relations and ESG Engagement	Etsy
Ella Chalfon	Managing Director of Sustainable Finance	Nomura
Emanuele Fanelli	Head of ESG — Fixed Income & Partnerships	Aegon Asset Management
Frank Kopfinger	Head of Investor Relations and Strategy	LEG Immobilien
Hanaa Helmy	CEO of EFG Hermes Foundation & Head of CSR at EFG Hermes Holding	EFG Hermes
Ian Parry	Principal Environmental Fiscal Policy Expert	IMF
Jason Mitchell	Co-Head of Responsible Investment	Man Group
Jim Burton	ESG & Sustainability Partner	Grant Thornton
Jonathan Vaas	Vice President of Investor Relations	Adobe
Jorge Collazo	Head of Investor Relations	Coca-Cola FEMSA
Juan Lin	Head of Investor Relations	Baidu
Kara Mangone	Global Head of Climate Strategy	Goldman Sachs
Karine Fourneron	Non-Financial Reporting & SRI	Orange
Keith Tuffley	Managing Director & Vice Chairman and Global Co-Head, Sustainability & Corporate Transitions	Citi
Laurent Lhopitallier	Head of ESG Performance	Sanofi
Leon Kamhi	Head of Responsibility	International Business of Federated Hermes
Lucy Rodriguez	Chief Communications Officer	CEMEX
Marisa Drew	Chief Sustainability Officer & Global Head Sustainability Strategy, Advisory and Finance	Credit Suisse
Marjorie Whittaker	Managing Director — SEC Regulatory Matters & ESG	Grant Thornton
Mark Babington	Executive Director — Regulatory Standards	FRC
Mark Lewis	Head of Climate Research	Andurand
Mary Wroten	Director of Sustainability and ESG	Ford
Maurice Loosschilder	Global Head of Sustainability	Signify
Mili Fomicov	Climate and Equity Strategy	Andurand
Monica Girardi	Head of Investor Relations	ENEL
Nathalie Pistre	Head of Research and SRI	Ostrum Asset Management
Paul Chisnall	Director, Sustainability	UK Finance
Rafaella Dortas	Head of ESG	BTG Pactual
Rahul Ghosh	Managing Director at Moody's ESG Solutions	Moody's
Raine Naude	ESG Analyst	Allan Gray
Rick Ogden	Managing Director	PAG
Roelfien Kuijpers	Global ESG Client Officer and Head of Client Coverage for Ireland, Scandinavia and the UK	DWS
Sofiya Kirsanova	Deputy Head of Investor Relations	Gazprom
Swami Venkataraman	Senior Vice President at Moody's Investors Service	Moody's
Trisha Taneja	Head of ESG Advisory	Deutsche Bank
Wolfgang Kuhn	Independent Strategy Consultant, former Director of Financial Sector Strategy at ShareAction	

Part 1: The Mechanics of Transitioning to a Low-Carbon Economy

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Developments in The ESG Landscape

This issue of the Investor Update ESG White Paper is focused on the process of transition towards the low-carbon economy. Part I presents a comprehensive and current evaluation of the ESG landscape, including an overview of the regulatory developments in the major jurisdictions, and ongoing industry trends in ESG investing and integration of ESG considerations into corporate strategy.

The main developments discussed in this (first) section include:

- → Governments and regulators are increasing the pressure to decarbonise on the private sector
- → Large asset managers are increasingly phasing out their investments in fossil fuels and intensifying engagement efforts
- → There is still significant room for improvement – according to ShareAction, over 50% of investors have a flawed approach to ESG, including engagement on ESG issues
- → ESG data continues to be a challenge, underminding the effectiveness of the investment process
- → The EU is advancing its sustainable finance framework, with an increasing focus on sustainability reporting and corporate governance
- → The voluntary standard space is in continuous development, with the IFRS sustainability reporting initiative enjoying significant support
- → Many corporates are ill-prepared for the change: less than 30% of CEOs are concerned about climate change, the boards are lacking ESG expertise and over 80% of corporates' strategies are not Paris-aligned
- → Investors' demands for ESG data coverage and quality continues to grow

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1.0 Global and national transition goals

The past year has seen mounting efforts of the global community to prevent further damage and to mitigate the unavoidable effects of climate change.

The keystone of the international commitments to mitigate climate change is the Paris Agreement, which saw 195 countries agreeing to limit global warming to well below 2 degrees Celsius above the pre-industrial levels and aim to limiting it to 1.5 degrees. According to the 2018 Special Report of the Intergovernmental Panel on Climate Change, a temperature rise above 1.5 degrees will bring increased climate-related risks such as droughts, rising sea levels, and loss of ecosystems. Limiting the temperature rise to 1.5 degrees would help to minimise those negative impacts and avoid the worst consequences to the human population[1]. This is not an insignificant demand — to reach the 1.5 degrees goal, emissions need to decrease by 45% from 2010 levels by 2030. Despite the steady increase in national commitments, the global community is currently a long way from achieving this target. According to the UN, at the current rate, temperatures will increase by 1.5 degrees by 2040. An analysis of the current commitments of 75 countries (which represent around 40% of the parties to the Paris Agreement) has shown that the targets set by these contributions will result in the reduction amounting to less than 1% below the 2010 levels by 2030, in contrast to the required 45%[2]. These deficiencies were expected to be addressed at the COP26 conference in Glasgow in November 2021.

In the business context, the risks brought about by rising temperatures translate into tangible financial losses occurring in the near future. Currently, CDP estimates that companies are exposed to over $120 billion in costs linked to environmental risks in their supply chain in the next 5 years[3]. However, the changes required to address those risks require significant disruption of current business practices, including a rapidly reduced reliance on fossil fuels, a material shift towards renewable energy, a significant increase in investment in green innovation, and the expansion of carbon capture capacities to remove the remaining emissions from the atmosphere.

Achieving these goals requires active cooperation between international policymakers and private and public sectors. The current global regulatory direction aims to incentivise companies to consider the environmental and social externalities of their business models.

Considering that most of the current emissions originate from energy production, agriculture (including forestry and other land use), transportation, and industry, the pressure on these sectors is high. Global companies in high-emissions sectors are particularly exposed to transition risks, but at the same time, there is an opportunity for leadership stemming from the geographical scope and ample resources that create potential for large-scale positive impact.

The last two years saw an increasing number of corporates and financial institutions responding to the challenge, spurred on by national regulation and the increasingly apparent threat that climate change brings to the planet and their business models. 'ESG' as a concept and an investment trend is at the heart of this shift — the 'environmental' part of the acronym has taken the most prominent place in the minds of regulators, investors, and corporates due to the increasing urgency of addressing the climate emergency.

1 IPCC, Global Warming of 1.5 C. An IPCC Special report on the impacts of global warming, 2018
2 UN NDC Synthesis Report
3 CPD, CDP Global Supply Chain Report 2020, February 2021

These efforts have already produced notable results. The global offshore wind capacity keeps growing at a record pace despite the pandemic[4]; demand for renewable energy is increasing; the economic recovery plans emphasise 'green' investment. Germany, France, Spain, Denmark, Norway, and South Korea are among the top countries dedicating a large part of the recovery spending to sustainable opportunities. A number of prominent asset owners, such as Norges, have committed to cease investing in fossil fuels. In addition, the pandemic brought greater recognition of the previously overlooked factors under the 'environmental' umbrella, such as biodiversity, and social factors. However, the economic transition is a complex task and there is much that needs to be done. One of the significant challenges is to ensure that measures on climate mitigation consider social and economic factors. This difficulty is underscored by the evidence that most of the recovery funding has been used to support carbon-intensive industries to prevent further job losses and restart the economy[5].

2.0 Major regulatory developments

Despite the COVID-19 pandemic, 2020-2021 brought a flurry of ESG-related regulatory developments in many major jurisdictions. It was a particularly active year for the EU, with the adoption of the Taxonomy Climate Delegated Act, a proposal for a Corporate Sustainability Reporting Directive, SFRD, and an incoming sustainable corporate governance regime. The UK pioneered mandatory TCFD disclosure and, most recently, announced the new Sustainability Disclosure Requirements and the UK Green Taxonomy. The aftermath of the US presidential election brought a sharp change of course on ESG, including the renewed regulatory focus on climate reporting.

EU

NFRD Review

The Non-Financial Reporting Directive (NFRD) forms a central part of the European sustainability disclosure framework. Since 2018, the large European companies have been required to report on the policies, outcomes, risks, and KPIs linked to environmental, social, and employee issues. The NFRD introduced a double materiality concept, which requires companies to disclose sustainability-related risks to the business and the impact of the company's activities on society and the environment.

The 2020 consultation on the NFRD Review revealed significant deficiencies in the implementation of existing requirements, including the lack of comparability, reliability, and relevance of disclosures. Companies under the scope of NFRD incur significant costs in the process of non-financial reporting, as well as uncertain and conflicting demands on the content and placement of those disclosures. The double materiality approach, while useful in creating a comprehensive picture of ESG performance that is of interest to a wide range of stakeholders, was not effectively translated in corporate disclosures. Currently, few companies disclose the impact of their activities on sustainability factors, instead providing general policy statements that do not allow stakeholders to form a full picture of their ESG performance[6]. The introduction of additional sustainability disclosure requirements for the financial sector under the SFRD further emphasised this challenge.

4 World Forum Offshore Wind, Global Offshore Wind Report 2020 https://wfo-global.org/wp-content/uploads/2020/06/WFO_Global-Offshore-Wind-Report-2020.pdf
5 UNEP, Are We Building Back Better? Evidence from 2020 and Pathways for Inclusive Green Recovery Spending, March 2021
6 Alliance for Corporate Transparency Report, EFRAG climate

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In April 2021, the Commission adopted a proposal for a Corporate Sustainability Reporting Directive (CSRD), which would amend the current NFRD requirements, extending the scope to all large companies and introducing an audit requirement for the reported information. In addition, the CSRD will mandate companies to follow the mandatory EU sustainability reporting standards, which are currently being developed by the European Financial Reporting Advisory Group (EFRAG), which are scheduled for adoption in October 2022. The revisions proposed by the CSRD aim to ensure greater consistency and quality of sustainability reporting and to align corporate reporting with investors' needs under the SFDR. EFRAG is currently engaging with a range of stakeholders on potential approaches that could be adopted in Europe-wide sustainability reporting.

SFRD

The Sustainable Finance Disclosure Regulation (SFRD) constitutes a key part of the EU's sustainable regulatory framework, aiming to combat greenwashing and increase transparency around sustainable investment practices. SFRD establishes entity-level and product-level disclosure requirements that apply to most financial institutions in the EU and also to non-EU firms offering products in the EU. Most of these provisions came into effect in March 2021. The entity-level requirements mandate investment firms to disclose how they integrate sustainability risks into their investment decision-making process (Article 3), and how they consider (or chose to ignore) the adverse impacts of their investment decisions on sustainability factors (Article 4). Also, firms are required to outline the way their remuneration policy is aligned with the approach to the integration of sustainability risks (Article 5).

On the product level, investors have a choice whether to assess the impact of the sustainability risks on the financial returns, or to provide information on why they deem sustainability risks not relevant for a particular product (Article 6). A firm that discloses adverse impacts on sustainability factors, is required to provide this information for each financial product or to disclose why those impacts are not considered (Article 7). To address the proliferation of ESG-linked products, SFDR requires investors to distinguish between funds that have a sustainable objective (Article 9 funds), and funds that promote environmental or social characteristics among others (Article 8 funds). Depending on the type of fund, information on how the sustainable objective is achieved or environmental and social characteristics are met, needs to be disclosed.

If these funds reference an index, the disclosure should provide information on how that index is aligned with these goals.

The Regulatory Technical Standards, which define the principal adverse impacts to be reported by the financial institutions were finalised in October 2021 and are expected to apply from July 2022. The RTS provide disclosure templates for Article 8 and 9 funds, which require financial firms to provide the proportion of the portfolio allocated to sustainable investments.

The Taxonomy Regulation supplements the SRFD with regards to the products that promote or contribute to one of the identified environmental objectives. For those products, investors must disclose the specific environmental characteristics being promoted, as well as how and to what extent the portfolio is invested in those environmentally sustainable economic activities (Article 5 of the Taxonomy Regulation).

The requirements to distinguish between Article 8 and Article 9 funds and provide corresponding disclosures is expected to cut through the confusion caused by the proliferation of ESG funds with holdings in high-emissions companies. Detailed disclosures against the indicators included in the RTS will provide stakeholders with greater insight into the impacts of the firms' investment decisions. This insight will allow asset owners to evaluate the depth of the managers' commitment to sustainability, which is especially important in light of the ESG products being predicted to outnumber conventional funds by 2025. At the same time, this outcome assumes a robust industry response to the SFRD requirements, which could be undermined by their 'comply or explain' nature.

Another challenge to the effectiveness of the SFRD requirements is the availability of data required for an evaluation of the potential adverse impacts of a portfolio. Investors have voiced concerns with regard to the lack of relevant information — as of 2020, most companies do not report information in line with the SFRD requirements. For some, this translates into the possibility of a green bubble, should the requirements of sustainable investment prove to be too narrow. Another potential issue is penalising the (presently) high-emissions companies on a transition journey, as the EU regulatory push drives investors away from the polluting industries. Arguably, this could undermine the transition goals as traditional energy companies have a major role in achieving net-zero. Research shows that oil & gas companies are driving green innovation, producing a substantially higher number of green patents than firms highly rated on ESG performance[7]. Reducing the available funding could slow down the progress those companies could make in changing their business models towards a focus on renewable energy generation.

EU Taxonomy

The EU Taxonomy provides a common classification of economic activities that can be considered sustainable. In providing clear definitions of sustainable activities, the EU aims to minimise greenwashing and facilitate the low-carbon transition by directing capital towards objectively 'green' companies.

The Taxonomy regulation came into being in July 2020, with the fist Climate Delegated Act adopted in June 2021. This Act provides the first technical screening criteria on activities contributing to climate change mitigation and adaptation and is expected to apply from January 2022.

The delay in the adoption of the Climate Delegated Act was caused by the intensity of the stakeholder feedback (the draft delegated acts prompted more than 46,000 consultation responses). Some of the designations caused objections from the EU member states, in particular the omission of natural gas and nuclear energy. The Taxonomy designations have wide-reaching implications, which will impact the financing decisions of the EU investment bodies, national regulators, and the availability of private sector funding. The financing available to the nuclear projects designed to replace coal in the drive to decrease emissions, depends on its classification as a transition fuel. The difficulties of reconciling different approaches to climate transition were compounded by the social factor, expressed in the joint statement from thirteen unions representing nuclear workers, calling for the inclusion of nuclear power in the Taxonomy[8]. Following a positive outcome of the Joint Research Centre review, which concluded that nuclear energy does not cause significant harm to any of the Taxonomy objectives, nuclear energy and natural gas now seem to be closer to being included into the scope of the Taxonomy.

7 Lauren Cohen, Umit G Gurun, Quoc H. Nguyen, The ESG-Innovation Disconnect: Evidence from Green Patenting, NBER Working Paper Series, N 27990, October 2020 https://www.hbs.edu/faculty/Pages/item.aspx?num=59272
8 https://world-nuclear-news.org/Articles/Unions-call-for-European-taxonomy-to-include-nucle

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The implementation of the Taxonomy is likely to be further complicated by the data availability challenges. A study conducted by the UNEP FI and the European Banking Federation assessed the potential application of Taxonomy to banking products, which highlighted concerns around the availability, quality, and comparability of data, with a specific focus on the retail clients, SMEs, and assets based outside the EU. The lack of granular and relevant data made the 'Do No Significant Harm', 'Minimum Social Safeguards', turnover and revenue split assessments especially difficult. Also, the report highlighted the operational challenges around mapping the Taxonomy classification to clients' business activities as well as the increasing complexity of the internal processes[9]. This report is indicative of the challenges that will be encountered by many Taxonomy data users, including the asset managers.

ESG in corporate governance

In July 2020, the EC published a report on sustainable corporate governance, which identified several issues contributing to the prevalent focus on a short-term financial gain at the expense of the long-term (sustainable) value. Most of the identified challenges revolved around corporate governance structures and practices that incentivise short-termism by focusing on the immediate financial interests of shareholders at the expense of sustainability and long-term stakeholder considerations[10]. The report recommended regulatory action which would strengthen the role of directors in the promotion of long-termism, establish sustainability-related accountability structures, and improve integration of sustainability concerns in corporate governance. The report and its proposals attracted some criticism[11].

However, after a public consultation period, the EU Sustainable Corporate Governance Initiative has continued its work on legislative proposals, with the results being expected in the fourth quarter of 2021.

9 UNEP FI, EBF, Testing the application of the EU Taxonomy to core banking products, January 2021 https://www.unepfi.org/publications/banking-publications/testing-the-application-of-the-eu-taxonomy-to-core-banking-products-high-level-recommendations/
10 European Commission, EY, Study on directors' duties and sustainable corporate governance, July 2020
11 Mark J Roe et al, The European Commission's Sustainable Corporate Governance Report: A Critique, European Corporate Governance Institute – Law Working Paper 553/2020, 14 October 2020

Another important development in the field of European corporate governance regulation is the proposed initiative on the due diligence of corporate supply chains. The draft rules, produced by the European Parliament's Legal Affairs Committee, suggest an EU-wide mandatory due diligence disclosure requirements regarding risks related to human rights (including social and labour), the environment, and governance[12]. As outlined in the draft, corporate due diligence should cover all suppliers and sub-contractors, focusing on the ones that have been flagged as a major risk in the process. The proposals acknowledge the need for proportionality concerning the resources available to companies of different sizes. If the risks to human rights, the environment, or governance are identified, a company has to establish a due diligence strategy, which would specify the level and severity of the identified risks, disclose information on the value chain, outline the policies and measures that are intended to mitigate the risks and prioritise them if necessary. The proposals establish board-level accountability for the due diligence process and the appropriate adjustment of the remuneration policies. The rules are expected to be adopted by the end of 2021.

Regulating ESG ratings?

The ESG rating agencies could soon become part of the EU regulatory landscape, according to the stance of the European Securities and Markets Authority (ESMA). As observed in the ESMA's recent letter, ESG ratings have a significant impact on sustainable capital flows due to their role in ESG benchmark construction. As ESG evaluations tend to be used as a filter on the parent index, the resulting constituents depend on the methodology used by a particular rating provider. Considering the exponential growth of passive ESG investing, the lack of transparency and consistency around ESG rating methodologies presents a concern. The regulatory proposals include a legal definition of an ESG rating, public supervision to ensure transparency, and the conflict-of-interest requirements[13].

UK

The post-Brexit political landscape left significant uncertainties with regards to the exact shape of the UK regulatory approach to ESG. However, the past year demonstrated that climate considerations are a prominent feature on the government's agenda, with the added urgency brought by the UK hosting COP26 this year. The continuous focus on climate disclosure was evident in the introduction of the mandatory TCFD reporting obligations across all UK companies by 2025. In addition, the Industrial Decarbonisation Strategy, launched in March 2021, outlines the government's plan to enable net zero transition, which focuses on facilitating investment in low carbon sectors and consumer demand for low carbon products[14]. The strategy also sets out approaches to the adaptation of industrial processes and improving energy efficiency. According to this outline, the government expects emissions to reduce by two-thirds by 2035.

In the most recent development, the UK government issued a 'Roadmap to Sustainable Investing' in October 2021, which announced the Sustainability Disclosure Requirements and the UK Green Taxonomy. The new Sustainability Disclosure Requirements will enhance climate-related reporting in the UK by introducing new rules for companies and the financial sector. The sustainability framework being developed by the IFRS Foundation is said to form a key part of the UK's SDR. The government is expected to consult on the initiatives

12 https://oeil.secure.europarl.europa.eu/oeil/popups/ficheprocedure.do?reference=2020/2129(INL)&l=en
13 ESMA Letter to EC on ESG Ratings, 29 January 2021
14 https://www.gov.uk/government/publications/industrial-decarbonisation-strategy

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outlined in the Roadmap in 2022[15]. Notably, the government is also considering bringing ESG rating provider firms under the FCA's scope as part of its strategy to improve the quality of sustainability data.

These wide-ranging measures demonstrate a high level of commitment from the government. At the same time, the UK's efforts have attracted criticism over its failure to bring short-term targets and the lack of strong protections in the delayed Environmental Bill which is supposed to establish the post-Brexit environmental regime in the UK[16].

US

The Biden administration's early move to re-join the Paris Agreement encapsulated the change of course in the post-Trump US approach to ESG. The preceding years had seen the US lagging behind Europe in terms of sustainable regulatory development, with senior industry figures expressing scepticism around the materiality of ESG concerns. The current, much more proactive, regulatory attitude to sustainability issues can be illustrated by the recent Department of Labor's proposal to override the rules limiting pension plans' freedom to invest in ESG products, put in place by the previous administration. The renewed focus on ESG is underscored by the SEC undertaking a review of corporate climate-related disclosures over the course of 2021. The revisions to the mandatory climate reporting requirements, which are expected to come out in 2022, are likely to incorporate some of the TCFD recommendations[17].

3.0 Industry trends

Standards convergence

This year saw an increasing convergence trajectory around the voluntary ESG disclosure standards. In response to the investors' and corporates' desire for clarity and consolidation, the main ESG standard-setting bodies have engaged in a race to develop a single framework. So far, this has resulted in several new initiatives that do not yet provide a unified landscape to the data preparers.

One of the prominent recent developments is the merger between SASB and the International Integrated Reporting Council (IIRC) which formed the Value Reporting Foundation in 2021. The Value Reporting Foundation aims to provide a combined offering of the principles-based guidance on integrated reporting and more detailed industry-specific sustainability disclosure metrics. The focus remains on financially material sustainability factors primarily targeted at the investor audience. The long-standing finance industry bodies, such as IFRS and CFA are also in the process of developing their ESG disclosure initiatives, with IFRS proposals attracting considerable industry support. The World Economic Forum and the Big 4 accounting firms (EY, Deloitte, KMPG, and PwC) released another sustainability disclosure framework, which identifies the main ESG metrics that could be verified and assured. Both IFRS and WEF initiatives have attracted criticism for excessive focus on investor perspectives at the expense of a more balanced stakeholder approach. However, the IFRS' work on setting up the International Sustainability Standards Board

15 HM Government, Greening Finance: A Roadmap to Sustainable Investing, October 2021 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1026224/CCS0821102722-006_Green_Finance_Paper_2021_v5_Bookmarked_48PP.pdf
16 https://www.theguardian.com/environment/2021/jan/26/fury-as-long-awaited-uk-environment-bill-is-delayed-for-the-third-time?CMP=twt_a-environment_b-gdneco
17 https://www.sec.gov/news/speech/gensler-remarks-european-parliament-090121

(ISSB), which oversees the development of global sustainability disclosure standards, has already gathered support from a broad range of stakeholders, including the UK regulators.

Target-setting

Climate change mitigation and transition to a low-carbon economy require decisive corporate action. While many companies acknowledge the need to address environmental and social concerns and to incorporate the relevant policies, investors and other stakeholders cannot evaluate their performance without measurable targets. Companies that do set targets often have divergent approaches: they differ in the scope of entities and activities covered, the timeline, and the methodological approach. These differences result in incomparable data and hinder the evaluation process. The environmental context sets further, more specific demands: to ensure a meaningful contribution to the goals of the Paris Agreement, corporate targets have to reflect the scientific reality. Clear, science-based, and measurable targets are also advantageous for the corporates as they allow them to adjust strategic planning, improve resilience, and communicate their climate commitment to investors and other stakeholders.

The Science-based Targets Initiative (SBTi), set up in collaboration by CDP, World Resources Institute, the World Wide Fund for Nature, and the UN Global Compact, aids corporates that want to contribute to achieving net-zero by 2050, by helping them to set carbon emission reduction targets aligned with this goal. Current common approaches to achieving net-zero include reducing Scope 1, 2, and 3 emissions, carbon capture, and counteracting emissions by reducing emissions outside of the value chain. The Science-Based Targets Initiative tends to favour methods that do not significantly rely on carbon capture due to the uncertainties around the adverse effects and scalability of these technologies[18]. SBTi provides sector-specific guidance, which currently covers ICT, apparel, financial institutions, and power (with guidance for chemicals, oil & gas, transport, forestry, and aluminium in development). Companies can start their journey by submitting a letter of intent, develop an emission reduction target that will be validated by SBTIi, and disclose against that target annually. To date, over 1,200 companies have set a science-based climate commitment through this initiative[19].

Beyond Climate: Biodiversity and Social Metrics

Climate has been the primary focus of the sustainability agenda for most regulators, investors, and corporates. This is changing with the growing recognition of the importance of biodiversity. The World Economic Forum identifies biodiversity loss as the fourth-highest risk by impact and fifth by likelihood (with the top risks being extreme weather, climate action failure, and environmental damage)[20]. This risk translates to quantifiable economic loss. OECD estimates that ecosystem services (benefits provided by ecosystems that contribute to making human life both possible and worth living) provide benefits amounting to over $120 trillion a year.[21] While the progress is slow, deforestation has already been used as a reason for divestment in 2020.[22] This trend is bound to increase as biodiversity remains one of the key ESG issues throughout 2021. The key initiative in this area is the Taskforce on Nature-related Financial Disclosures (TNFD), which is currently developing a framework on the corporate reporting of biodiversity risks.[23] TNFD aims to develop a set of reporting

18 Alberto Carillo Pineda, Andres Chang, Pedro Faria, Foundations for science-based net-zero target setting in the corporate sector, September 2020
19 https://sciencebasedtargets.org/
20 Word Economic Forum, The Global Risks Report 2021, 16th Edition, January 2021
21 OECD, Biodiversity: Finance and the Economic and Business Case for Action, May 2019
22 Dom Phillips, Investors drop Brazil meat giant JBS, The Guardian, 28 July 2020
23 https://tnfd.global/

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recommendations which will build on the TCFD framework, focusing on providing investors with decision-useful information on nature-related risk. The rules are expected to come out by 2023.

Social factors have also been an underrepresented element in corporate ESG disclosures and investor decision-making. This has been changing since 2020, when the COVID-19 pandemic and the diversity considerations entered the mainstream ESG conversation. Several large investors, including State Street, have since called on companies to act on workplace and board diversity. Human rights is another growing concern for investors and regulators, especially in the context of the global supply chain. Gathering this data can be resource-intensive for large companies, but these businesses are also most at risk from supply chain malpractice.

ESG data and ratings

The availability and quality of ESG data continues to be a challenging field for many stakeholders. Within that, ESG ratings continue attracting divergent opinions regarding methodologies and the reliability of underlying data. The OECD report on environmental scoring highlights that for some providers, a high overall ESG score does not necessarily correlate with a positive dynamic in terms of emissions or waste. The reason for the low correlation is the fact that the measures that companies take to reduce their climate risk might have greater weight than environmental metrics. Considering the rating providers' influence on ESG-linked indices, this has important implications. The OECD study found that portfolios tracking several ESG indices do not always reduce exposure to highly polluting sectors relative to the underlying benchmark. Depending on a particular index (and the rating methodology used), the main constituents can range from practically identical to the non-ESG parent index to being completely different constituent companies.[24] On the data-users' side, there is a corresponding demand for a more tailored ESG data offerings that could aid investors in mitigating these concerns. This demand led to the growing number of data providers changing their focus from a singular ESG rating to a diverse set of products which focus on different aspects of corporate ESG performance.

24 Boffo R., C. Marshall and R. Patalano (2020), ESG Investing: Environmental Pillar Scoring and Reporting, OECD Paris http://www.oecd.org/finance/esg-investing-environmental-pillar-scoring-and-reporting.pdf

4.0 ESG investing

The prominence of ESG and sustainability considerations in investment decision-making has continued to rise. By July 2021, ESG funds accounted for 90% of total equity inflows[25]. By 2025, ESG strategies are predicted to constitute more than half of all European funds[26]. Active managers still represent the majority of the ESG capital, but the ESG index funds are also seeing a continuing upward trend. This is reflected in the market demand for MSCI ESG ratings and indices being predicted to overtake the core index services[27].

Investment in ESG is often perceived as a 'win-win' opportunity: the growing links between ESG-positive portfolio and increased returns, as well as positive societal and environmental impacts, offer an attractive combination. It is reasonable to assume that the increasing inflows to the companies that perform well on ESG factors facilitate energy transition and support the transition to the low-carbon economy in line with the net-zero goal. However, challenges persist.

On one hand, investors are getting increasingly vocal in their demands that companies improve their ESG track record and provide comprehensive disclosure. Some of the prominent 2021 examples included BlackRock's push for companies to disclose against TCFD, State Street and Legal & General demanding transparency on diversity. Institutional investors increasingly view ESG integration as the key driver of corporate success, and prioritise diversity and climate risk in their engagement[28]. Finally, ESG factors are beginning to fuel shareholder activism, as demonstrated by the successful campaign conducted by Engine No. 1 against ExxonMobil on their climate action strategy.

Despite these positive developments, the investment industry remains inconsistent in its treatment of ESG considerations. According to last year's data from ShareAction, over 50% of the world's largest asset managers have a flawed approach to ESG, with the largest managers demonstrating particularly poor performance. The lack of a comprehensive approach to ESG is evident in the lack of governance arrangements such as board-level oversight (present in only 21% of institutions) or financial incentives linked to the sustainability factors (7%). Climate change is frequently referenced in the investment policies, but most portfolios are not yet Paris-aligned. Climate-related engagement with corporates is typically focused on reporting, with most investors supporting resolutions on disclosure rather than decarbonisation or strategic measures. Biodiversity and human rights concerns are significantly less well-integrated: 76% of investors do not state specific human rights commitments, 68% do not have any policy references to biodiversity, and only 28% exclude companies violating international human rights frameworks[29]. The study results also showed an overall low level of support for ESG proposals, with the voting patterns not being influenced by a PRI membership.

The growth in the number of ESG funds is constantly attracting greenwashing concerns, with many funds criticised for holding companies in high-emissions industries. The SFDR has been welcomed as an important step in resolving this issue by requiring investors to classify their funds between Article 6, 8 and 9 and fulfil the corresponding disclosure requirement. While the increasing regulatory pressure and improvements in availability of ESG data are

25 https://www.ftadviser.com/investments/2021/08/11/esg-accounted-for-90-per-cent-of-fund-inflows-in-july/
26 https://www.ft.com/content/5cd6e923-81e0-4557-8cff-a02fb5e01d42
27 https://www.barrons.com/articles/msci-says-growth-in-esg-outpaces-its-traditional-index-business-51614041864
28 EY, 2021 proxy season review, January 2021 https://www.ey.com/en_us/board-matters/what-investors-view-as-top-strategic-drivers-and-threats
29 ShareAction, Point of No Returns https://shareaction.org/research-resources/point-of-no-returns/

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likely to improve the degree of ESG integration at financial institutions, these changes will have to be advanced due to the limited timeline available for the transition.

The current slow pace of decreasing in carbon emissions is resulting an unrelenting increase in the level of yearly reductions needed to meet the goals of the Paris agreement. This means that investors will have to take a much more active approach to corporate engagement to avoid the increasingly shrinking pool of investment opportunities. Such initiatives as the Net Zero Investment Framework, developed by over 70 investors with over $16 trillion combined AUM, indicate that investors are scaling up their efforts towards decarbonisation[30].

5.0 Corporates

For many companies, the rising importance of material ESG factors (and especially climate concerns) has become impossible to ignore. The continuous evolution of regulatory frameworks and shifts in investor preferences emphasise the strategic importance of environmental and social considerations. The increasing awareness of the necessity of meaningful ESG integration to business resilience is reflected in the growing number of SBTi signatories.

For many sectors, decarbonisation would necessitate fundamental changes to the existing business model. The example of Orsted, which transitioned from a fossil fuel energy provider to a market leader in offshore wind, shows that this task is achievable. However, significant barriers remain, ranging from market incentives to the pace of scientific innovation. As a result, most corporates are still slow in taking meaningful action to address the most pressing environmental and social concerns. The widespread popularity of the ESG investment trend, coupled with the lack of insight into the material importance of sustainability can result in a marketing-focused, 'greenwashing' approach with corporates adopting low-cost measures such as formal ESG policies which are ineffective even in the perception of the corporate insiders[31]. There is a lot to be done in order to achieve the transition goals: last year's TPI (Transition Pathway Initiative) assessment showed that more than 80% are currently off-track for a 2 degrees target[32]. The target-setting is an important part of a credible climate strategy, however many corporates find it a significant challenge. In addition, companies that respond to stakeholder demands by setting net-zero targets, do not always substantiate their goals.

ESG governance

Corporate governance is at the heart of any successful integration of ESG and sustainability considerations. Conviction of the board and senior management is necessary for a company to evaluate its environmental and social risks and opportunities, consider its external impacts, and adjust the strategy accordingly.

ESG integration and low carbon transition present a novel challenge to the directors and senior management: instead of solely focusing on increasing profits and satisfying shareholder demands (which are traditionally focused on the short term), they are faced with environmental factors underpinned by scientific evidence and social developments that are of interest to a much wider range of stakeholders. Effective integration of these factors into business operations requires new competencies as well as a recalibration of incentives and accountability structures.

30 https://www.iigcc.org/resource/net-zero-investment-framework-for-consultation/
31 https://www.navexglobal.com/en-gb/company/press-room/environmental-social-governance-global-survey-reveals-strong-adoption-across-public-private-companies
32 TPI, State of Transition Report 2020

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The recognition of the importance of corporate governance and the links between the pursuit of short-term value and negative environmental and social impacts came with the debates on the purpose of the company and the responsibilities of the board directors. The concept of 'stakeholder capitalism' has been gaining increasing recognition, with many of the largest investors, including BlackRock, pushing companies to consider wider stakeholder interests (including the environment, employees, and society) in their strategy.

There are mounting arguments to view ESG considerations as part of the directors' fiduciary duty to the company. In the UK, the Companies Act 2006 enshrines the 'enlightened shareholder value' approach by mandating the directors to consider stakeholder interests. This is reinforced by the UK Corporate Governance Code, which states that the board should promote the 'long-term sustainable success of the company' and that remuneration policies should be aligned with this focus. In the US, directors have a more explicit obligation to act in the interests of shareholders. However, the integral importance of material ESG factors to the company's bottom line suggests that those interests do not have to be conflicted. This link is becoming more and more evident as the understanding of the financial implications of environmental and social risks evolves. Even in the US, which has traditionally been considered a shareholder-centric jurisdiction, attitudes are slowly shifting towards the stakeholders' direction. The Statement on the Purpose of a Corporation, signed by the CEOs of 181 large companies in 2019, stated that companies need to consider the interests of employees, customers, and the local communities. This newfound focus was put to the test by the COVID-19 pandemic in 2020, with many companies finding their crisis response scrutinised. This scrutiny showed that the stakeholder momentum needs time and reinforcement to become a meaningful influence on corporate behaviour: a subsequent analysis indicated that the Business Roundtable 2019 signatories did not demonstrate significantly better pandemic response[33].

Boards are likely to be slow to adapt to the new demands due to a lack of environmental or social experience. A director who understands the science behind climate change is more likely to successfully identify the relevant risks, evaluate the impact on the business and incorporate these factors into corporate strategy. The same can be said for other environmental and social factors.

A widely cited study of the Fortune 100 companies showed that less than 30% of directors had any ESG credentials, with very few directors having climate or human rights experience[34]. Last years' PwC directors' survey demonstrates the results of this dynamic: less than 50% of the respondents stated that ESG is a regular part of the board agenda, while only 38% thought that ESG factors have a financial impact[35]. The executive management demonstrate a similar pattern with only 30% of CEOs including climate change among their top concerns and 60% not incorporating climate change into their strategic risk considerations[36]. The proliferating Chief Sustainability Officer posts are also susceptible to this challenge. Many companies have been criticised for appointing individuals with a marketing or communications background and failing to ensure that this role influences organisational decision-making. There is some evidence that CSO appointments without relevant expertise are largely symbolic, with little association between the appointment and improvements in ESG performance[37]. Introducing ESG-linked elements into executive compensation is increasingly considered a key element of ESG governance, with the majority of large investors backing this trend. Identifying and

33 KKS Advisors, TCP, COVID-19 & Inequality: A test of Corporate Purpose, September 2020
34 Tensie Whelan, US Corporate Boards Suffer from Inadequate Expertise in Financially Material ESG Matters https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3758584
35 PwC, PwC 2020 Annual Corporate Directors Survey
36 PwC, PwC 24th Annual Global CEO Survey
37 Gary F Peters, Andrea M Romi, Juan Manuel Sanchez, The Influence of Corporate Sustainability Officers on Performance, Journal of Business Ethics, 28 February 2018

incorporating meaningful ESG metrics in remuneration is far from a straightforward task, considering the need to include clearly defined and trackable ESG indicators that can be directly influenced by the executives. An increasing number of companies are willing to take on this challenge, with half of the FTSE 100 linking their executive remuneration to ESG targets.[38]

Risk governance is another part of corporate governance structures that require significant changes to allow companies to address ESG-related risks. Most significantly, the risk function faces the difficulty of addressing risks that are outside the conventional financial perspective and do not yet have established quantification methodologies. The OECD identifies other ESG risk management challenges, such as the lack of internal communication between individuals responsible for different aspects of ESG, as well as the prevalence of the box-ticking approach[39]. Board expertise is also critically important in this context, considering the directors' responsibility to set the organisational strategy and provide oversight. Improving ESG risk management is high on the agenda of many companies, including financial institutions. A 2021 survey of risk professionals in the financial sector indicates that the industry recognises the scale of the challenge: only 33% were able to describe their approach to ESG risks as effective, while 47% placed improvements in their ability to manage ESG risks as a high priority[40].

ESG Reporting

Corporate disclosure is probably the most explored aspect of ESG, due to the investor and regulatory pressure as well as being a comparatively simpler task. According to KPMG, 80% of companies worldwide report on sustainability[41]. Despite the widespread adoption of different ESG reporting practices, there is a significant potential for improvement as the content of the disclosures tends to fall well short of stakeholders' expectations.

A key element of effective reporting is identifying the material ESG factors that a company needs to disclose. The definition of materiality varies depending on the reporting framework that a company adopts, but the two major perspectives cover those ESG factors that can impact a company financially and the impact a company can have on environmental and social factors[42]. Investors tend to focus on financially material information but the external impact of companies' activities should not be discounted as it is of significant interest to a wide range of stakeholders including consumers, media, rating agencies and NGOs as well as specialised investors. Using the example of climate change, many investors are interested in the potential impact that climate change can have on a business, as well as the impact the business can have on the environment.

Most ESG corporate reporting is focused on climate indicators, but these disclosures are far from comprehensive. A significant number of companies approach climate disclosure as a box-ticking exercise: for example, TCFD reports frequently fail to provide information on strategic resilience to climate risks and adaptation measures taken by the company.[43] Medium to long-term climate strategy, governance, risk management processes, and methodologies are rarely presented clearly. Out of 300 large European companies, only 40% disclose how climate risks impact their business model, while only 35% provide an outline of their ESG-related governance arrangements. Companies also tend to omit information on whether their

38 https://www.ft.com/content/609eae5e-1576-4081-9340-5d5001b5b02e
39 OECD Business and Finance Outlook 2020: Sustainable and Resilient Finance
40 Deloitte, Global risk management survey, 12th edition, February 2021
41 KPMG, The KPMG Survey of Sustainability Reporting 2020, December 2020
42 A 'double materiality' approach expressed in the guidelines to the EU Non-Financial Reporting Directive.
43 EFRAG, European Reporting Lab, How to improve climate-related reporting, February 2020

policy targets have been met — only 25% provide this data. Other environmental indicators are reported on even more sparingly with 70% not providing any information on biodiversity and only 10% disclosing quantitative targets on their use of natural resources[44]. This is likely to change with the rising stakeholder interest in biodiversity. Several industry initiatives, with the most prominent example being the Taskforce on Nature-related Financial Disclosures (modelled on the TCFD), are working on developing biodiversity-related reporting standards that will guide companies on reporting relevant information in this area.

The social factors represent another developing area in sustainability reporting, reinforced by the latest socio-political developments and the COVID-19 pandemic. Workforce and board diversity is a prominent topic within this trend. Human rights, especially in the context of global supply chains, is another emerging point of interest. A very low percentage (22%) of companies currently report on their human rights due diligence and this is likely to change with the incoming European sustainable corporate governance regime mandating human rights due diligence of the supply chain.

6.0 State of play

Most governments and regulators are intensifying their commitments to reduce emissions and to accelerate the transition to the low-carbon economy. The EU continues to advance its ESG regulatory regime, establishing a classification of sustainable activities, mandating comprehensive investor disclosure, and developing European non-financial reporting standards. The UK is also in the process of actively setting up a robust environmental regime with its own version of the Green Taxonomy and mandatory sustainability disclosures and the US is starting to catch up by focusing on the accuracy of climate disclosure. Despite the relatively slow pace of these developments, the overall regulatory trend is irreversible, leaving the corporates to embrace and adapt to this new reality.

The investment industry is scaling up its response to the growing focus on sustainability with an increasing number of ESG-related products. Due to the divergent approaches to sustainability, some of these products continue to attract greenwashing accusations. The European regulatory package on sustainability aims to address this issue, with the UK working on a comparable regime and other major jurisdictions likely to follow. Most asset managers are still far from the consistent integration of ESG factors into their strategies, but this is likely to improve with increasingly regulatory pressure.

The pressure is especially intense on fossil fuel-reliant sectors, which face significant disruptions to their current business models. For most, this is a challenging endeavour that requires reallocation of resources, adjustments to strategy, governance arrangements, and reporting practices. Currently, not all corporates recognise the importance of making the change, with this issue being partially driven by a lack of board expertise and executive buy-in on one side, and the persisting short-term market pressures on the other. Overcoming these problems will be a key element of addressing the mounting physical and transition risks that threaten severe financial losses.

Companies also have to prepare to respond to the mounting regulatory and investor demands for reliable disclosure covering the wider scope of ESG concerns that are intensified by the SFRD. Businesses that fail to rise to this challenge are likely to find themselves subject to intense pressure from investors in the form of challenge, engagement, constructionism and activism.

44 Alliance for Corporate Transparency, 2020 Research Report

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ESG Investor Benchmarking & Targeting

Investor Update's ESG Benchmarking provides valuable business intelligence on your true ESG standing, compared on a like-for-like basis with your genuine peers. Given the significant growth in ESG AUM and profile it is crucial that corporates understand the wide range of market expectations of them across each element of E, S and G... but also to understand which specialist ESG investors are already on their register and which to target.

We will identify, track and benchmark ESG focused funds as part of our service, identifying ESG focused funds that are underweight or absent in you compared to your domestic, international and aspirational peers. As part of our analysis, we break down your target list of ESG investors into active and passive pools and identify their investment potential at fund level.

Through this unique approach Investor Update is able to

- Calculate the amount of ESG-mandated capital currently invested in your stock and compare weighted ESG investment levels with a focused peer group
- Quantify the potential value of inward ESG investment in terms of additional purchasing power
- Identify specific ESG funds, active and passive, thematically, by market cap and by geography
- Discover which ESG indices key ESG focused funds benchmark themselves against and the amount of capital backing that each index has
- Deliver your detailed analysis at fund-level via our proprietary visualisation portal and in a board-friendly report

A Differentiated Approach to ESG Advisory

Building on the foundations of our Benchmarking Analysis, **Investor Update's ESG Advisory Team** identifies the gaps between our clients' strategies and choices around ESG and those of the best-in-class peers identified. This evidence-based approach is producing rapid, commercially impactful results for some of the largest companies from all major sectors.

Clear action points are identified and recommendations made ranging from high-level and strategic initiatives through to tactical optimisation ideas, all related to specific examples of excellence with clearly signalled outcomes and benefits presented in a series of board-level reports.

Our ESG Consultancy services include

- Gap Analysis on Reporting & Disclosure, Narrative & Comms and Strategic Priorities
- Deep-Dive into ESG-linked Executive Compensation and Board Competency
- Enhancing Passive Investor inflows by examining Index membership criteria
- Strategies for increased Active ESG Money engagement with buy-side ESG Teams
- Design & execution of Specialist ESG Perception Studies and ESG Roadshows

Part 2: The ESG Experience — Reflections of Some of the Most Influential Global Entities

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1.0 ESG Integration: How Industry and Finance are Addressing the Drive to Decarbonise

During the summer of 2021, more than fifty entities gave generously of their time and insight to share and shed light on the most challenging elements of ESG and the decarbonisation transition. What follows are a series of highlights of those interviews, focusing on distinct but related observations that come together within critical categories of the ESG world. All quotes have been verified and approved by the contributing companies, representing the views of those leaders at the time of publication.

As a result, this paper represents the most comprehensive and timely perspective on the ESG journey by those individuals best placed to comment on and drive the change that is required. It reveals the collective responsibility of the developed world as well as the individual aims and ambitions of each entity and their response to the global, urgent challenge currently facing the natural world and the financial world, society and those that govern them.

We have seen a massive recognition from the capital markets participants of the importance and relevance of sustainability information.

Most stakeholders observed the evolution of the industry discourse around ESG and sustainability. The conversations moved on from misperceptions around the longevity of the ESG concept and its potential negative impact on financial returns towards net-zero targets, stakeholder considerations and reputational risks as a more routine part of company performance evaluation. **Marisa Drew, Chief Sustainability Officer & Global Head Sustainability Strategy, Advisory and Finance at Credit Suisse** highlights the stark shift in perception:

> *"In terms of ESG awareness and appetite, it is almost night and day between four years ago and today. The initial challenges were about convincing people of the longevity and seriousness, that you did not have to sacrifice returns to deliver positive social and environmental outcomes and that the sustainable finance market was not just a flash in the pan."*

Bryan Esterly (Director of Research at the Value Reporting Foundation which maintains the SASB Standards) emphasised the changing attitudes of the investor community:

> *"What we have seen, in terms of the evolution of this space, is a massive recognition from the capital markets participants of the importance and relevance of sustainability information in assessing securities and taking a view on enterprise value. And this is a very different conversation from 10 years ago: then, the conversation was about why sustainability information matters for understanding the companies' value. There would be a lot of pushback from certain audiences around the relevance and importance of sustainability for the capital markets. This conversation has massively shifted towards much more specific aspects of sustainability information, how to measure it and disclose it to investors, and how investors can best use this information in investment decisions, embedding it in the investment processes, products, and stewardship."*

The Paris Agreement goals sharpened stakeholder attention and led to a more specific focus on the timeline to net zero by 2050, as highlighted by **Trisha Taneja (Head of ESG Advisory at Deutsche Bank)**:

> *"I think there is more focus now to the transition with the goal of net carbon neutrality by 2050. If you look at the sustainable finance market a few years ago, that was not the ultimate objective. The ultimate objective had no clear end date and it was not as focused on climate transition."*

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2.0 Key challenges of low carbon transition and ESG integration

Despite the current lack of a unified approach to ESG or decarbonisation, most stakeholders' opinions revolved around several key challenges.

Decarbonisation pathways and misaligned incentives

Currently, neither corporates nor the financial sector, on average, have sufficient clarity or common understanding of the low carbon transition pathways across all relevant sectors. Largely, the climate action in the private sector is focused on long-term net-zero targets, which are often not supported by a credible transition strategy. In addition, financial stakeholders continue to struggle with reconciling the global decarbonisation imperative with their primary focus on delivering client returns because the relationship between ESG factors and financial profits is still relatively ambiguous.

On the corporate side, uncertainties around transition pathways result in hesitation to commit to climate targets in the face of unclear implementation routes — especially in sectors that do not yet have well-developed technological sustainability solutions. In addition, corporate leadership is subject to the continuing short-termist pressures exerted by investors which make it difficult to find a balance between maintaining profitability and long-term climate commitments. At the same time, many corporates are rising to this challenge, with some working to resolve the cross-sectoral challenges by participating in industry initiatives, partnering with academia in an effort to facilitate green innovation, and exerting influence throughout their supply chains. Regulatory influence was cited as a powerful decarbonisation driver for corporates, especially in markets where investor interest in ESG concerns is still in development.

The challenge will be the alignment around the transition pathways.

Bridget Fawcett (Global Head of Strategy and Co-Head, Sustainability and Corporate Transitions, Banking, Capital Markets and Advisory at Citi) spoke about the need for greater understanding of the transition strategies:

> *"I think that the challenge will be the alignment around the transition pathways by sector and the fluency level of the corporations. They need to develop an understanding of their emissions, their emissions pathways and how those align to the emission pathway targets that the financial services sector is setting." She continued, "There are different levels of fluency on sustainability and ESG topics, and range depending on the sector that you are in or the region you might be living in. Accelerating fluency around these topics has been the biggest challenge over the last 12 months."*

This uncertainty exacerbates the hesitancy to set robust commitments on the corporate side:

> *"The biggest concern companies have is about committing to net-zero targets. It is not because they do not fundamentally believe in the value and importance of doing so, but corporations have to publicly report short-term earnings and are trying to balance that with long-term relevance. The challenge is getting to the mindset that yes, we can make a 2050 net-zero commitment, but we are not sure how we are going to get there. There is a fear factor for certain leaders and hesitancy to commit to targets that they are not sure how to deliver, or that might require a different portfolio of assets and competencies. There is also a recognition that transition may be a transformation of your business, and that is a really hard thing to execute. It's easy to put it on paper, but to transform your business, that may be at risk because of supply and demand shifts, from fossil fuels to renewables and the associated value chain is really hard to imagine, even if it is the right thing to do."*

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Hanaa Helmy (CEO of EFG Hermes Foundation & Head of CSR at EFG Hermes Holding) highlighted how existing misalignment between the policy and regulatory goals exacerbates the gap between intent and implementation in the private sector:

> *"We hear a lot of good talk during conferences, but once people go back to their offices or countries, it is business as usual. During the conferences, parties often discuss the 'what' and not the 'how'. So, we have a problem — we know what the problem is, we have an acronym for the problem, we have a definition of the problem, but how do we address this problem? The ultimate goal would be for governments and regulators to align to provide an attractive ecosystem for investment."*

Roelfien Kuijpers (DWS' Global ESG Client Officer and Head of Client Coverage for Ireland, Scandinavia and the UK) highlighted the role of state action in mobilising decarbonisation efforts:

> *"In my mind, companies will follow the lead of governments. If you codify net-zero commitments into law (which the UK government was the first to do), put into place standardized public policy frameworks and enforce them through regulators and other stakeholders, then companies — no matter what industry they're in — will actively participate in the transition to net-zero."*

Andrew Lee (Managing Director, Head of Sustainable and Impact Investing, UBS Wealth Management) pointed out the difficulties of reconciling the needs of the low carbon transition with the existing business models:

> *"The challenge is the consistency of many different business models and exposures with the low carbon economy. We have seen many net-zero commitments from companies and asset managers over the longer time frame, all of whom are now trying to figure out concretely the credible path to get there. From an asset manager's perspective, it is about evolving or developing new investment strategies that align to net-zero and decarbonisation objectives while still delivering for investors on risk and return that they expect and need. These commitments require thinking about what it means in terms of asset allocation, portfolio positioning, expected tracking error, and risk and return and whether that meets the needs and expectations of investors. Reconciling climate goals with investment objectives, which remain a priority for investors, is a significant challenge that the industry needs to navigate."*

It is about evolving or developing new investment strategies that align to net-zero and decarbonisation objectives while still delivering for investors.

Common language and approaches to ESG and climate investing

The financial sector has not yet developed a common language or common approaches to environmental and social considerations, including climate. Several participants outlined a number of ESG-linked investment strategies which reflect varying client demands and understanding of the area. These inconsistencies in investors' approach to ESG and different demands for the corporates, which depend on a particular fund strategy, further complicate the task of strategic integration of ESG concerns for the corporates, including the choice of metrics and reporting frameworks.

In addition, financial stakeholders themselves vary in their views on the role of financial industry in the decarbonisation process. One of the particularly contentious debates is around divestment from fossil fuel-intensive companies versus engagement with a goal to assist them in transition. Many interviewees fell on the side of engagement, citing greater opportunity to create positive environmental impact. Other stakeholders pointed out the slow speed of change resulting from investor engagement, which does not align with the

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pace of decarbonisation needed to achieve the Paris goals. Several stakeholders called for the regulators to take a more active role in developing common standards and creating appropriate incentives by aligning the policy mechanisms with the state-level carbon reduction targets.

Jason Mitchell (Co-Head of Responsible Investment at Man Group) spoke about the need for a shared cross-jurisdictional approach:

> *"One challenge is trying to come up with a common definition of what 'sustainable' means. The EU has probably the most rigorous framework around that, but it travels less well in other jurisdictions. We see some differences in the UK and clearly, the US is far behind. So the challenge is trying to get our head around what sustainability represents, and to create products and analytics around that."*

Marisa Drew (Credit Suisse) illustrated the continuous difficulties with integrating ESG concerns alongside tradition financial metrics:

> *"Typically, with a new financial instrument in banking, the exercise has been to assess it against the risk-adjusted return associated with that particular asset class. You were not adding that third lens, which alongside risk and return, is the 'impact' that the investment dollar can create. This is a real paradigm shift in financial markets — to think about environmental or social impact alongside returns, and then to define and measure it in a way that investors can embrace."*

The pace of the required change is also a challenge:

> *"We know how serious the climate issue is, and how it is getting ever more critical that we mobilise capital quickly to meet the challenge and help our clients and our organization transition. So we know that we need to move faster, but it can be difficult to change embedded patterns of behaviour. You are asking peers and investors to get onboard with a complex topic and new market paradigm and to operationalize it — and do it fast — and that's hard."*

Trisha Taneja (Deutsche Bank) emphasised that the variety in investors' approaches to ESG reflects on corporates' lack of direction on how to formulate and report on their strategy:

> *"When corporates are trying to set targets and develop or communicate sustainability strategy, they are hard-pressed to know what investors are looking for because it depends on which ESG investment strategy is being used and that varies from fund to fund. It just depends on the investor — whether they are adopting an exclusionary approach, or whether they are assessing corporates' ESG risk. Even within the same investor, it varies from fund to fund. So, the biggest challenge for the issuers is to understand what each investor is looking for and respond to that."*

Andrew Lee (UBS Wealth Management) provided an example of different approaches to sustainable investing that can coexist within cross-asset investment portfolios:

> *"Many of the exposures in our sustainable investing portfolios are actively managed strategies that focus on different aspects of sustainability. On the equity side, for example, one of the key allocations is to strategies that focus on ESG leaders — companies that are leading from an operational footprint perspective. Complementary to this is a momentum approach focused on those companies that are not yet leaders but which show improvement on ESG metrics or performance. Another one focuses on sustainable themes, with exposure to companies whose products and services address critical environmental and social challenges. Finally, a key strategy on the equity side is engagement for impact, where the fund manager actively contributes through engagement with corporate management to drive positive ESG change in ways that benefit performance as well as sustainability outcomes. These are complemented by sustainable fixed income exposures like development bank bonds and green, social and sustainable bonds, as well as sustainable and impact alternative investments."*

ESG data and reporting deficiencies

The quality and availability of ESG data continues to be a significant challenge for the financial sector. According to the interviewees, even the data on Scope 1 and Scope 2 emissions often lacks consistency, with the information issues only intensifying with regards to less commonly established environmental and social indicators. The lack of globally accepted ESG reporting standards and limited corporate resources are the key factors contributing to this challenge. These problems intensify in the context of mid and small capitalisation companies and emerging markets.

David Harris (Global Head of Sustainable Finance, Data and Analytics at LSEG) spoke about the corporates' challenge to tailor their ESG disclosure to diverging market demands:

> *"There is a variety of different informational needs that the investment and finance community have with regards to sustainability. And it is a real challenge for many issuers to understand what to report, how to report and where to report, to respond to those needs. Often, the issue is understanding how this information gets collected, aggregated and consumed, as well as how it impacts investment decisions; often rather than reviewing sustainability reports directly, most investors will use a variety of data providers, and they may also contact companies to ask for additional information."*

Partly as a result of these uncertainties and partly due to the inconsistent regulatory demands and the dearth of resources, the availability and quality of ESG-related data suffers. **Kara Mangone (Global Head of Climate Strategy at Goldman Sachs)** emphasised the increasing importance of high-quality ESG data:

> *"It is very hard to assess risk or deliver on climate goals if you do not have the data to tell you where you are going. When we look at carbon footprinting for us and our clients, we find that the reported emissions for many sectors today is low — only half of the MSCI universe currently reports Scope 1 and 2 emissions. Given we are still in early innings, the quality of climate-related disclosure should be prioritized over quantity."*

A leading charitable foundation highlighted the challenges of acquiring and evaluating data on ESG factors outside climate:

> *"Data is one of the most difficult challenges. For something like emissions, it is a complex process, but at least you can get the data from most large companies. For something like cybersecurity, it is incredibly difficult to know what type of data you should use."*

Emerging markets — gradual pace of transformation

Addressing environmental and social concerns in the context of emerging economies comes with specific jurisdiction-dependent challenges. Many countries are heavily reliant on fossil fuels and in those areas the pressure to accelerate the low carbon transition are less prevalent, mirrored by weaker client demand for ESG or climate-focused investment products. Due to the economic dependencies, the regulatory push to decarbonise might be relatively less intensive. At the same time, many countries have adopted mid-century

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decarbonisation goals, and are starting to align their regulatory incentives in line with these targets, which reflects on corporates' strategic planning. In addition, market pressures to integrate ESG considerations are developing, exerted by the European investors guided by domestic regulation and the overall global trajectory towards integrating ESG into the investment approach.

Akber Khan (Senior Director, Al Rayan Investment) spoke about the obstacles that fossil fuel-reliant economies face in the context of the global drive towards decarbonisation:

> *"In the Gulf, perhaps unsurprisingly with some of the lowest cost oil and gas in the world, the moves towards renewable energy have been extremely modest. As long as the resource remains underground and global demand stays strong, hydrocarbons will remain the primary driver of regional economies for decades to come. While it is impossible for decision makers to be unaware of the global push to slash carbon emissions and intensity, strategies will lean towards offsetting activities and efficiency enhancements. But the bulk of the emissions will likely continue."*

In terms of the investment industry, the client pressure to incorporate ESG factors is minimal, but the process is still influenced by the global trend:

> *"Many aspects of the S and G in ESG are fundamental to us as an ethical manager. With the majority of our clients from the region, we do not, as yet, get questioned on how we incorporate climate change to our investment process. This does not stop us from questioning companies on their plans because the rest of the planet will start making asset allocation decisions based on broader ESG criteria. The bulk of the capital globally is rapidly moving in that direction."*

3.0 Corporate ESG integration and target-setting

Setting specific, measurable targets tied to material ESG factors has become one of the key elements of corporate strategy. Despite the increasing necessity to set these targets, the rate of adoption varies significantly, influenced by regional regulatory standards, organisational factors, market structure and many other influences. This section will discuss the leading forces incentivising companies to adopt ESG-linked goals and focus on decarbonisation, and the persisting obstacles on this path.

Target-setting: incentives and challenges

Most private sector stakeholders cited investor pressure as a primary driving factor behind companies' ESG and sustainability commitments. This was mostly attributed to the market-driven accountability structures which require corporate leadership to be attuned to investor preferences. Pressure is also increasingly exerted by other capital providers, as banks and insurance companies increase their own ESG integration processes. The second most frequently cited influence was regulation, driving both investors and corporates to adopt comprehensive approaches to climate and other elements of ESG — however, this factor is region-specific. Mounting societal and consumer pressure, along with the generational change have also been mentioned as important drivers in this context.

The quotes below illustrate financial stakeholders' perception of the main incentives behind corporate ESG target-setting.

Bridget Fawcett (Citi) emphasised the way that market accountability structures impact corporate priorities:

> *"On the whole, while companies are moving towards a purpose-driven, total stakeholder mindset, companies have to answer to shareholders on a quarterly basis. So, while they are concerned about all stakeholders — customers, governments, regulators, communities, etc. — one constituent that they have to meet publicly every quarter is the investors."*

Companies are concerned about the impact their ESG performance could have on their ability to obtain capital from other sources, as noted by **Jim Burton (ESG & Sustainability Partner at Grant Thornton)**:

> *"…lenders, banks and insurance companies are asking about carbon-related matters and other ESG-related metrics as they are making their insurance and lending decisions. So even if they haven't been specifically contacted, they [the customer] are aware that those contacts are occurring within their sector."*

Trisha Taneja (Deutsche Bank) observed the strong European regulatory push having a noticeable effect on the pace of climate target adoption:

> *"In Europe, you would be hard-pressed to find a company that has not set climate targets. We work a lot in the private market spaces: private equity, and small-cap companies, and they are all setting climate targets. If companies do not have a credible plan for decarbonisation they are in danger, because there is a lot of regulatory oversight that is transforming the infrastructure of capital markets. And by credible, I mean science-based targets that are aligned with the Paris Agreement."*

If companies do not have a credible plan for decarbonisation they are in danger.

Many participants observed the significant impact of the EU sustainability regime on companies' environmental target-setting, with the extra jurisdictional influence extended by European investors who endeavour to align their portfolios with the domestic regulatory requirements. The EU's direction was widely recognised as a globally leading example of regulatory facilitation of low-carbon transition by most interviewees, with some noting flaws in the existing regime.

The comments below demonstrate the interviewees' views on the existing policy and regulation decarbonisation levers.

Alberto Carrillo Pineda (Co-Founder and Managing Director of the Science-Based Targets initiative — SBTi) highlighted the importance of state-level policy decisions in facilitating corporate action, expressing a positive view on the EU and UK approaches:

> *"Right now, we have some incentives coming from many countries that are adopting some form of net-zero targets. But in many cases, those long-term net-zero targets still send a weak signal to companies because they are not yet implemented in policy and translated into short-term incentives. Right now, the strongest incentives that companies could have are the NDCs (Nationally Determined Contributions) that countries set. Those impact the context in which companies will operate for the next ten years, which is the relevant planning for most companies. Right now, the NDCs that the UK and Europe have are ambitious and they send the right signal. The US has made a significant improvement compared to where they were in the previous administration, but it's still in the early phases. In most other countries, I don't think we have the level of ambition that is needed at the country level, and that makes it challenging for companies that have global supply chains."*

You need two things to happen for the energy transition to work properly: policy and technology.

While the EU presents a strong example of regulatory-led climate response, **Casey Dwyer (Portfolio Manager, Andurand Capital Management)** emphasised the need for more targeted policymaking to incentivise decarbonisation in the context of EU ETS market:

> *"…you need two things to happen for the energy transition to work properly: policy and technology. And you get the technology response and investment response when the policies are intelligently designed. If you look at the companies that still get their allowances for free in the EU ETS, which is all of the industries covered apart from the power industry, where is the incentive for them to really think about the impact of carbon pricing deeply? They have been receiving those carbon allowances for so long, they have almost become dependent. Many of them made good money under the radar. You need intelligent policy design to give people the incentive to understand the changes that are happening. In other words, the burden is not purely on the companies, it's on the policymakers as well."*

Despite the decisive push for decarbonisation targets supported by investors and regulators in many jurisdictions, numerous challenges still prevent or slow down their adoption for many stakeholders. While climate risk awareness has become ubiquitous within the investor community and the views on corporate purpose are shifting towards long-termism and stakeholder consideration, short-term pressures remain a significant influence on corporate behaviour. In addition, many sectors do not yet have a clear methodology to achieve net-zero, which further complicates the target-setting processes for the corporate leadership. The accessibility and quality of data, as well as lack of resources also present significant challenges.

The comments below represent some of the present challenges around ESG target-setting.

Alberto Carrillo Pineda (SBTi) emphasized that, while the importance of setting meaningful carbon reduction targets and Paris alignment is evident to most, the misalignment between different stakeholder groups blur the view of ESG at the managerial level:

> *"There are misaligned incentives across different stakeholders — in some cases the management of the company, in some cases the investors, the political context… companies are already aware of the importance of setting ambitious climate targets, but they don't always find the right incentives to go through the process."*

He elaborated on the specific organisational obstacles and misperception of climate risk:

> *"The concept of net-zero has brought great clarity, I think everyone understands it means that we need to get rid of most of the emissions that we are releasing into the atmosphere today, and so that means that all sectors across the economy need deep decarbonisation. I think the main hurdle that the companies face now is the internal buy-in to go through the target-setting process. For some companies, Scope 3 remains an unbroken challenge because, on one hand, the level of Scope 3 data management is still poor across many companies, and on other hand, companies find it difficult to set up a strategy to manage their Scope 3 emissions because it requires a different way to embed the climate goals within the structure of the company. For instance, it requires active involvement from the procurement department."*

Companies need to have a decarbonisation strategy encompassing both short and medium-term (2030) goals, and an articulated pathway to get there.

The resource remains a significant obstacle for smaller corporates:

> *"If you have a company that has a very small sustainability department, it is very difficult for them to handle a significant transition process. Or if the sustainability department is mostly focused on regulatory compliance and is hosted in the less strategic areas of the company — it doesn't have the power to drive a transition like this. If companies are in that situation of less advanced management of climate change, we can build capacity with those individuals but they may not be necessarily empowered to drive change. In that case, the pressure from investors makes it important, because then that sends a signal to the management."*

Bridget Fawcett (Citi) highlighted the existential challenge that decarbonisation places on some corporate managers:

> *"When we advise clients, we believe that net-zero by 2050 is tablestakes, and that is where the world needs to move and is moving, and of course this is the focus of both the government and private sector at COP26. And as a part of that commitment, companies need to have a decarbonisation strategy encompassing both short and medium-term (2030) goals, and an articulated pathway to get there with accountability, and a capital expenditure plan that supports that. So I think what we are going to see as part of the transition is a real test of leadership. And the challenge is, if you look back at some of the transitions that have been underway, the future path is not always clear for leaders."*

Marjorie Whittaker (Managing Director — SEC Regulatory Matters & ESG at Grant Thornton) observed the companies' reluctance to commit to a goal without a clear pathway:

> *"There is hesitation to set targets until you have an idea that you will definitely be able to do it. There are so many factors outside of companies' direct influence — you just have to*

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> *accept that there will be some amount of emissions that you can't remove, and you may have to purchase carbon credits. A lot of companies want to put something out there, but there is a hesitancy to do so until you know that it's something that you are going to be able to achieve."*

Ella Chalfon (Managing Director of Sustainable Finance, Nomura) highlighted how long time horizons can present a challenge in setting net-zero targets:

> *"Nomura has put careful thought into its sustainability strategy, recognizing that it is important to truly understand how targets will be met. In September we committed to achieving net zero greenhouse gas emissions for our global operations by 2030 and for client lending and investment portfolios by 2050. As a sign of our intent we will deploy $125bn in sustainable financing over the next five years. We also joined the Net Zero Banking Alliance. As an investment bank, it's a more complex task compared to commercial lenders, to measure and attribute emissions on the one hand and green and social financing on the other.''*

The transfer of wealth to the millennial generation is driving the change in preferences.

Investors and ESG target-setting

Considering the investors' influence on corporate ESG strategy, it is important to examine the forces driving their own approaches to climate and ESG. While some of the interviewees mentioned the effects of the generational shift, the most prominent factors were client demands and, to a lesser extent, regulation. Most observed growing client interest in specific ESG strategies as well as general integration of ESG into investment decision-making and stewardship, with the emerging markets dynamics overall mirroring Europe, the UK and US, but at a more gradual pace. At the same time, the domestic client demands vary significantly depending on the jurisdiction, which, in some cases, makes for a reduced demand for environmental targets. In this context, foreign share ownership by large global investors can play an important role in facilitating net-zero commitments.

The quotes below illustrate the main drivers influencing investor behaviour in the climate target-setting context.

Trisha Taneja (Deutsche Bank) draws a parallel between the pressures faced by the consumer goods companies and investment firms:

> *"If you look at companies in the consumer sector, they are facing pressure from their customers. The same thing is driving change in investor behaviour. I think the transfer of wealth to the millennial generation is driving the change in preferences from the individual consumer, whether that's how they invest their money or how they buy their goods."*

Emanuele Fanelli (Head of ESG — Fixed Income & Partnerships at Aegon Asset Management) illustrates how client influence, alongside regulatory requirements, is shaping institutional ESG integration in European markets:

> *"Our three main assets are based in the Netherlands, the UK, and the US. For the assets that we manage in Europe and the UK, there is this tendency to, apart from creating labelled products, make the current mainstream funds more responsible or sustainable because of the expectations from clients, regulators and civil society. There is pressure from these clients where the focus is on thinking: 'It's great that you have your impact fund, but what about the other funds that I am investing in?'" Client interest in ESG also plays an important part in steering portfolio managers: "(for some portfolio managers) they haven't historically been considering ESG factors, or they haven't been calling it ESG, so it's a continuous dialogue. Of course, they will listen to the Responsible Investment Team, but the voice of the regulator or a client is different."*

Investors from non-European jurisdictions provide a less homogenous view. Investors have significantly increased expectations around ESG as noted by **Rick Ogden (Managing Director in the Absolute Returns strategy at PAG)**:

> *"In the last two to three years, our investors have become much more focused on our ESG efforts — how we think about it and how we incorporate it into our decision making process. Most, if not all of our LPs have very clear ESG goals and expect their asset managers, where possible, to align ESG priorities with theirs. However, this can be a challenge given the absence of universally accepted ESG standards across our global investor base. We are looking to address this by aligning our frameworks to best practices."*

Comments from **Akber Khan (Senior Director, Al Rayan)** illustrate jurisdictional differences in client demands:

> *"Within what investors currently view as an ESG framework, similar to any active manager, our focus has long been the G. ARI is an ethical investor — our investments must be Sharia-compliant — so a number of the metrics within S are critical to us. We are prohibited from investing in producers of goods such as tobacco, weapons, alcohol, companies involved in gambling, and so on. To satisfy our requirements, we ask for specific disclosures on business activities and certain financial information to determine Sharia-compliance. While our requests are somewhat different from general ESG reporting, there is overlap and we glean important information from the increased ESG disclosure on management and their approach towards stakeholders. Our client base is predominantly regional institutions — pension funds, SWFs, insurance companies, family offices and the like — but to date no client has mandated us to incorporate broader ESG principles within our investment approach. But we are certain it is just a matter of time before this changes. Most regional sovereign wealth funds are signatories to the One Planet Sovereign Wealth Fund Coalition, an initiative that promotes environmental transition. In this context, international investors play a significant role in setting the direction for listed companies: "a number of listed, blue-chip companies in the Gulf are much further advanced in aligning themselves with ESG best practice than government bodies; management teams of listed entities are being put on the spot more often by increasingly ESG-sensitive,*

global investors. That said, expecting governments in countries producing the majority of the world's fossil fuels to restrict their carbon emissions in the near term doesn't make sense and would add to energy market chaos. Consider the broader impact of OPEC announcing a major cut in oil output, Qatar limiting LNG exports or some of the largest plastic or aluminium makers declaring production restrictions."

In addition, many investors have a nuanced view on the utility of the net-zero targets in recognition of the fact that the recent flood of 2050 commitments does not necessarily equal a robust and realistic decarbonisation strategy, unless it's supported by a clear methodology. Some have also expressed understanding for companies facing methodological and other difficulties in target-setting.

It is not enough to just state that a company has net carbon neutral targets — they now have to explain how they are going to achieve them.

Trisha Taneja (Deutsche Bank) emphasized the developing investor demand for comprehensive climate plans:

"The investor expectation is shifting, it is not enough to just state that a company has net carbon neutral targets that will be achieved by 2050 — they now have to explain how they are going to achieve them. For example, if your net carbon neutrality plan is based entirely on purchasing offsets, that may not be as credible, even though you may be net carbon neutral by 2050. What investors are wanting is more strategic detail and to see how your business is transforming."

Jason Mitchell (Man Group) acknowledged that many industries are still at the initial stage concerning climate action:

"As of this writing, only 20% of the world's largest, listed companies have made net-zero commitments. If you make a commitment and you fail on it, you will likely be penalised, you'll lose credibility. I'm a little bit more forgiving of companies that are making commitments, because I believe that this is a process and you want to make it as inclusive as possible in the beginning. I am not condoning bad behaviour, but it might be a bit messy and noisy, you want more people committing and you want more frameworks like the IGCC that tighten and harden those commitments into interim targets."

Many of the investor interviewees set their own portfolio decarbonisation commitments, however this trajectory is also subject to the local market structures and client pressures outlined above. In addition, several participants expressed concern with regards to the consequences of some of the widespread approaches to portfolio decarbonisation, such as the use of exclusion screens.

Emanuele Fanelli (Aegon Asset Management) questioned the validity of the Paris portfolio alignment supported solely by corporate targets:

"If you think about companies incorporated in Europe, in the next couple of years, all of them will set up an implicit or explicit climate target. They kind of have to — either due political pressure, investor pressure, or stakeholder pressure. The question is: 'Is that enough? Are those targets, which are self-claimed to be Paris aligned, enough to create a portfolio that is Paris aligned?'".

Mark Lewis (Head of Climate Research, Andurand) noted the flaws of the exclusionary approach to low-carbon portfolio construction in the context of facilitating decarbonisation in the real economy:

"All of the large institutional managers are in this race almost with net zero products, and we have this deluge of commitments and pledges from many of the world's largest corporations around net-zero by 2050. It got me to thinking that, as an industry, we are looking at the wrong thing, because it's easy for companies to make pledges about long-term future and say — of course we believe in net-zero by 2050 and will be aligned by then. And by the same token, it's actually easy for institutional investors to exclude coal from their portfolios as a means of ticking the net zero box. And somehow, many institutional investors have become so comfortable with their own understanding of what net-zero is that they are almost not keeping up with what's happening in the real world, but it's what happens in the real world that matters. If you are a large power generator with a large amount of coal in your portfolio, and it accounts for 90% of your emissions, and you are subject to the laws of that jurisdictions then you are either going to be compliant with net-zero, or you're not going to have a business. So if you are excluding a company like that from many institutional portfolios because of the role coal still plays in its activities, but the company itself has made a pledge to be net-zero by 2040, and is subject to legally binding net-zero targets and policy mechanisms that will deliver it — on what basis are we, as an asset management industry, taking the decision to exclude companies that are in jurisdictions whose laws are designed to achieve net-zero? That's a question that many institutional asset managers are not even asking."

Wolfgang Kuhn (Independent Strategy Consultant, former Director of Financial Sector Strategy at ShareAction) suggested that the current approach to investing needs a fundamental change to enable the financial industry to drive transition:

"The requirements for investors need to change, and the definition of fiduciary duty is a vital piece of this. At ShareAction, we heard a lot, particularly from Anglo-Saxon companies, that even if they wanted to pursue sustainable objectives, they are not allowed to do so by law. I think this is a serious societal problem that needs to change — investors need to be mandated, either by law or by their clients, to take responsibility for the social and environmental damages that come with creating profits".

Corporates on ESG target-setting

Most corporate issuers we spoke to set science-based carbon reduction targets, emphasizing the strategic importance of a robust climate and ESG strategy. Consumer and societal pressures, along with regulation were the most frequently mentioned motivating factors in the context of target-setting. Carbon reduction targets commonly encapsulated Scope 1 and 2, with several companies citing difficulties with evaluating and setting reduction targets for Scope 3. Several interviewees discussed plans to employ carbon offsetting as one of the measures that will allow them to achieve net-zero. Many interviewees also aim to shift to a complete reliance on renewable energy in the short to medium term, or have already completed that shift.

The following quotes illustrate the corporates' perspective on the environmental target-setting and strategic integration of sustainability considerations. They also provide examples of the scope, timelines, associated challenges and approaches taken.

Deb Wasser (Vice President, Investor Relations and ESG Engagement at Etsy) spoke about the Etsy decarbonisation journey, from carbon offsetting to science-based targets:

"We are proud to be the first major online shopping destination to completely offset carbon emissions from shipping and packaging and we have been a carbon neutral company since 2019. All of our operations, including our marketplace, are powered by renewable energy. In early 2021, we set long-term carbon reduction goals that are validated by the Science Based Targets initiative: our new Net-Zero by 2030 goal includes

> *a 50% absolute reduction in our Scope 1 and 2 greenhouse gas emissions and a 13.5% absolute reduction in our Scope 3 greenhouse gas emissions."*

She emphasised that the main difficulty will lie in reducing Scope 3 emissions:

> *"It is easier for us to meet our targets for emissions that we control. Our biggest challenge will be meeting reductions in our indirect Scope 3 emissions, since we do not control the shipping on our platform. In part, we will be relying on influencing public policy and our vendors and partners to decarbonise the shipping sector. We are actively participating in public policy activities related to decarbonising transportation and increasing the availability of clean energy. In addition, specifically on Scope 3, in September we launched an ambitious sustainable packaging initiative. Etsy now offers planet-friendly packaging to enable US sellers, the majority who believe it is important to run a socially responsible and environmentally friendly business, to join us in reducing the environmental impact from e-commerce. This initiative is not just about meeting our goal to be net zero by 2030 — we know that consumers care about the impact of their purchases We have a lot of conviction that an initiative like this can drive business growth, so you can expect us to leverage this launch in the buyer experience with a focus on driving conversion and loyalty to our brand."*

Baidu's carbon emission reduction and carbon neutrality target were set against the backdrop of China's pledge to reach carbon neutrality by 2060 and to achieve carbon peak by 2030.

Frank Kopfinger (Head of Investor Relations and Strategy at LEG Immobilien) provides an outline of LEG's climate strategy, demonstrating the impact of the state commitments on corporate change:

> *"We published a transformational corridor, which allows us to align with the Paris targets and also the German Climate Act that has been enforced to ensure compliance with the Paris Accord. Germany must become climate neutral by 2045, and the government has set out clear sub-sector targets, which include real estate. Our corridor provides sub targets in line with this legislation, including goals for 2024 and 2030, to give some guidance on how we think we need to develop."*

Lucy Rodriguez (Chief Communications Officer at Cemex) outlined the package of measures designed to reduce the company's emissions and achieve net-zero:

> *"We have been working for years to decrease our carbon footprint using several levers: improving energy efficiency, expanding our use of alternative fuels and renewable energy as well as increasing clinker substitution through alternative cementitious materials. With these levers and appropriate public policy support, the cement industry can be an important pillar of a green and circular economy. Our CEO recently announced a new 2030 carbon target, the most aggressive in the industry, of 450 kgs CO_2/ton of cementitious materials, representing a 40% reduction from the industry baseline. Additionally, under this framework we set a new scope 2 goal of 55% of clean energy by 2030. These new 2030 targets were validated by the SBTi according to the well-below 2°C scenario, currently the most aggressive pathway available for our industry."*

Lucy further elaborated on the path to net-zero CO_2 concrete by 2050:

> *"With regard to our 2050 net-zero CO_2 ambition, we do see CCUS as a fundamental contributor for mitigating the carbon footprint. To reach the 2050 goal, we are relying on CCUS technologies as a lever for about 35% of the mitigation. These technologies will require significant investment and need to be developed and scalable over the medium and long term. In addition, we are researching and trying to accelerate a very unique attribute of concrete: the process of recarbonation. Concrete, in its built form, actually absorbs CO_2 from the atmosphere over its lifetime. And finally, although its contribution would be minor, carbon offsetting is one of the levers for our carbon neutrality 2050 ambition and focuses mainly on carbon removal projects like reforestation."*

Juan Lin (Head of Investor Relations at Baidu) spoke about Baidu's carbon reduction goals in the context of wider state-level approach to climate action:

> *"Baidu's carbon emission reduction and carbon neutrality target were set against the backdrop of China's pledge to reach carbon neutrality by 2060 and to achieve carbon peak by 2030. Our goal is to reach carbon neutrality by 2030, covering Scope 1 and 2 emissions. This will involve improving building efficiency, reducing transportation emissions, employing carbon offsets, and working with our suppliers. After we achieve this goal, we plan to continue working on reaching negative carbon emissions and contributing to the national 2060 target."*

Gazprom's multifaceted environmental initiatives also form an important part of the state approach to energy innovation:

> *"Gazprom Group has short-term and mid-term targets for GHG emission in place and successfully hit these targets thanks to the number of measures applied. For the record, in 2020 Gazprom Group cut its GHG emissions by 17 million tons or 11% in 2020, from 237 to 210 mln tonns. Largely it was a result of the reduction in carbon intensity by 8% in gas business, which noticeably exceeded the planned target of -1.4% for 2020. Measures that constantly help Gazprom reduce its carbon footprint are energy efficiency enhancement during the gas transmission process, technical maintenance of the gas infrastructure and modernization of the gas compressor stations. Notably, all of these measures are included in Gazprom's maintenance CAPEX. As part of our decarbonisation strategy, Gazprom is also investing in R&D on hydrogen technologies based on pyrolysis and carbon capture approach. Recently Gazprom has signed an agreement with the Russian Government on drafting the Roadmap on Russian hydrogen strategy, where Gazprom is to be a core player for the strategy realization."*

The single largest emissions area is the production of the food we sell, and we are prioritising our efforts with our suppliers to tackle agricultural emissions.

Chris Griffith (Group Investor Relations & Corporate Development Director) illustrated Tesco's approach to Scope 3 emissions:

> *"Emissions from our products and supply chain — often referred to as Scope 3 emissions — make up more than 90% of our total footprint. We have recently announced a new commitment to address these emissions, reaching net zero by 2050 and aligned to 1.5 degrees. This commitment covers all emissions across our entire value chain, including emissions in our supply chains, the use of our products and our customers' dietary choices. Whereas Scope 1 and 2 emissions are within our control, to tackle Scope 3 we will need collaboration with suppliers and wider industry groups, along with supportive public policy. We know that the single largest emissions area is the production of the food we sell, and we are prioritising our efforts with our suppliers to tackle agricultural emissions. We don't yet have all the answers, but it is vital that we set out an ambitious commitment and take action now."*

Maurice Loosschilder (Global Head of Sustainability at Signify) spoke about Signify's progress on reducing carbon emissions:

> *"We announced achieving carbon neutrality in our own operations last year, which includes Scope 1-2 and parts of Scope 3 covering business travel and logistics. Our carbon neutral journey started 10 years ago with reporting our carbon emissions globally in our annual report. Since then, we reduced our emissions by more than 70%, and offset the remaining emissions to reach carbon neutrality in September 2020. We*

> *work collaboratively with our logistics partners to bring down the carbon footprint. Some examples are the use of most the carbon-friendly vessels, re-routing, or loading degree optimization. And we source 100% renewable electricity globally."*

Within the current commitments, there is also a significant focus on increasing and amplifying their positive impact:

> *"We have four big doubling commitments: we want to double the amount of circular revenues; double the amount of revenues from products that contribute to food availability, health and wellbeing, and safety and security; double the pace of the Paris Agreement to drive emission reduction over our full value chain; and double the amount of women in leadership positions. And we have a list of programs that we are already running, but we want to strengthen and continue — such as maintaining carbon neutrality, using 100% renewable electricity, increasing the amount of climate action revenues to 72% by the end of 2025, maintaining zero waste to landfill, and phasing out plastic packaging from all our consumer products by the end of 2021."*

More and more companies are understanding that climate risk is technical, and they need technical expertise.

With regards to social and governance goals, most corporates focus on board and senior management gender diversity, customer satisfaction, social inclusion, supply chain standards, health and safety. **Frank Kopfinger (LEG Immobilien)** highlighted the difficulties LEG encountered in setting a quantitative governance target that would match their corporate ambition:

> *"We wanted to have one measurable target, which is always hard to achieve — we did not want to make it with number of accidents, because typically, there aren't luckily many of them at our end. And this is why we came up with our Sustainalytics rating, because a big focus of the Sustainalytics rating is on governance. That's why we said we want to keep and maintain our very strong score of 10.4, which puts us among the top 2% of their coverage."*

Carbon emissions target-setting is an ongoing challenge for many corporates. While the strategic importance of setting a science-based net-zero commitment is clear to most, internal and external factors such as conflicting management incentives, slow pace of sustainable innovation, ESG data quality and resource availability present significant obstacles on this path. Regulation is the key driver of net-zero commitments, which restricts progress to the limited number of jurisdictions with robust state-level targets, such the EU. Investors, which represent another important lever of influence in the context of corporate target-setting, generally recognise the necessity and urgency of climate action. At the same time, they are led by diverse client demands, which, depending on the jurisdiction, increasingly support integration of ESG factors into the investment process and GHG reduction, but are not uniformly net-zero aligned. State net-zero commitments and global investors can play a significant role in jurisdictions where the domestic market pressures to decarbonise are relatively weak. Another contributing factor to some investors' hesitancy to push companies to net-zero commitments is the uncertainty around target-setting as a measure of effective carbon reduction strategy, especially in absence of clear pathways in certain sectors. Finally, investors' views on portfolio decarbonisation approaches also diverged, with some expressing concern with regard to the real-world consequences of especially strict or exclusionary strategies.

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4.0 ESG governance

Board competencies

When speaking of the ESG-related corporate governance challenges, most investors and advisors observed a significant variety in board competencies and sophistication on ESG-related issues, especially regarding climate change. Several interviewees emphasised the prevalence of board members with social credentials as opposed to more technical environmental expertise. Companies in sectors already exposed to significant disruption due to the shift towards the low-carbon technologies are more likely to include board members with material expertise in climate risk and sustainability, which reflects the increased pressure to adjust their business models. Company size is another influencing factor — mid-cap companies are less likely to have board directors with specific ESG-related experience, and more likely to appoint a single individual to be responsible for all matters across the ESG spectrum.

Interviewees' opinions were split concerning the merits of establishing a dedicated ESG or climate-focused board position, with several participants pointing out that this practice might lead to the lack of balanced discussion or isolate these issues. Assigning ESG-related responsibilities across the board can facilitate deeper integration of ESG and the cross-departmental collaboration within the organisation.

The counter-argument to appointing a board member with ESG oversight responsibilities is that everyone should have some kind of ESG specialism.

The following quotes illustrate the interviewees' views on the ESG-linked board competencies and responsibilities.

Trisha Taneja (Deutsche Bank) observes an increase in corporate awareness of the need for technical expertise and corresponding investor pressures:

> *"More and more companies are understanding that climate risk is technical, and they need technical expertise to fully understand the impact of ESG risks on their business and their business value, including the senior management level. I think there is also a greater expectation from investors for this technical expertise to exist in-house and to be integrated with the financing functions, not only including Treasury and CFO, but also at the board level to complement the strategic thinking of the board."*

An important part of this dynamic is the need to take advantage of the transition opportunities:

> *"Boards are starting to recognise that there is a commercial opportunity in selling solutions that help the transition to a low carbon economy. A good example is green hydrogen: there is a large amount of research that is going into green hydrogen and into understanding how it could be useful. What sort of investments could we get? I think that is very much part of the strategic planning."*

Marjorie Whittaker (Grant Thornton) pointed towards the difficulties that mid-cap corporates encounter on their journey to integrate ESG and climate:

> *"Many companies typically don't have a chief sustainability officer or team members with broad ESG expertise. Typically, the maturity level that our clients are at, there is usually someone in the senior management team who has been appointed to lead the ESG efforts — and not just climate, everything under E, S, and G. When they start digging in, the appointed individual quickly realises that there are a lot of topics that are constantly expanding, and they realise that they are going to need some help to do a good job, particularly with topics like climate and greenhouse gas emissions."*

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In the context of ESG governance structure, **Jason Mitchell (Man Group)** expressed concern that resting ESG responsibilities with a single individual might be detrimental to integration unless everyone has a degree of involvement:

> *"The counterargument to appointing a board member with ESG oversight responsibilities is that everyone should have some kind of ESG specialism. Otherwise, there is a big risk that you marginalise it within a board if you make one or two people responsible for it. Boards are responsible for strategy, but they are also responsible for culture, so it should not rest with one single person, it permeates the company so widely that all board members need to be responsible for it."*

Leon Kamhi (Head of Responsibility, International Business of Federated Hermes) also highlighted the need for balanced discussions at the board level, which involve all relevant parties:

> *"One should definitely have the right skills and experience in the boardroom, including climate risk, and that is really important. But if only one person in the boardroom has the particular knowledge, they might not always be right in their contentions. You have to make sure that the dynamics of the board isn't such that there is domination from one party — you have to able to balance their inputs with other inputs, whether it's from outside consultant or other board members."*

David Curran (Co-Chair of the Sustainability and ESG Advisory Practice at Paul Weiss and the Executive Director of the ESG and Law Institute) pointed out that cooperation between senior management, boards, and all corporate departments is necessary to address the variety of ESG issues that impact the business:

> *"At many companies, ESG has not historically been a board-level issue — so boards are now furiously moving to get up to speed on ESG issues. Currently, ESG sits in very different places in an organization, and if they're not coordinated at some level, there could be challenges."*

These structural flaws can be illustrated with the challenges linked to making progress on board diversity:

> *"If you are committed to creating better diversity and inclusion within your management, it is important to not only look at the human resources function that has been running this, but to also look at the fundamental way that you attract people to your organization. Who are the recruiters you use? What kind of money do you dedicate? Do you go to a different college to recruit? There is also progress to be made to ensure that diverse candidates have the opportunity to serve on a public company board — even if they have never served on one in the past. There must be a joint effort between companies, placement firms and others to ensure there is proper training and engagement so that those who have never served on a board are afforded the opportunity to step into those roles."*

On the corporate side, most interviewees emphasized the strategic importance of ESG factors, which are given a high level of priority within their corporate governance structures, including the board and senior management. The main approaches to ESG governance outlined by the interviewees included incorporating ESG into the mandate of the existing committees and creating separate ESG/sustainability committees containing key senior management. Most referred to having a board-level position with the broad range of ESG responsibilities. Several companies highlighted their efforts to avoid isolating ESG concerns by not assigning oversight to a single department or a committee and distributing them within

the company instead. Regarding specific ESG credentials of the board members, some of the areas mentioned by the interviewees included legal and regulatory competence, and sustainability experience drawn from the previous board-level positions.

Lucy Rodriguez (Cemex) illustrated ESG governance structure which covers board and executive strategic involvement:

> *"A Sustainability Committee, established in 2014, supports the Board in setting the company's sustainability strategy, evaluating the ambition of our targets and our performance against those targets, notably in the areas of Climate Action and CO_2 Management Strategy. The Sustainability Committee provides guidance to our Chief Executive Officer and senior management team regarding our strategic direction on sustainability. This Committee consists of four Board members who meet quarterly to analyse and discuss the progress on our ESG strategy. In addition to the Board-level oversight of climate-related issues in the organisation, the Executive Committee and our CEO review monthly the CO_2 strategy issues and global and year-to-date results on the key CO_2 KPIs by region. In addition, CEMEX has created a Global CO_2 Taskforce, which is a multidisciplinary group including functions such as Sustainability, Operations, Technology and Energy, R&D, Planning, Procurement, Communications and Public Affairs, Human Resources and others."*

You cannot let perfection get in the way of progress, and the accounting evaluation system is inherently imperfect.

Frank Kopfinger (LEG Immobilien) shows the ongoing evolution of the ESG governance structures within the company:

> *"Our CEO is heading the Sustainability Committee and, currently, corporate responsibility is a function under the CEO within the communications and corporate responsibility department. However, this is going to change. I am heading the strategy department and I was involved in drawing up the ESG strategy — we integrated ESG responsibility into the strategy team because it is not only about communication — we need to make sure that it is embedded in our corporate strategy and that we achieve the targets that we have communicated."*

Chris Griffith (Tesco) illustrates the increasing organisational importance of ESG:

> *"The CEO and senior leadership team are key to driving change and momentum in the business — they take the lead in championing the importance of this area and ensuring it is embedded in our strategy and business decisions. The Board is fully engaged across the range of sustainability considerations and authority is delegated to the Corporate Responsibility Committee, established in 2012, to oversee progress against our strategy. The CR Committee is chaired by Lindsey Pownall OBE, a Board level, independent Non-executive Director and comprises five other Board Directors. Committee meetings are attended by two members of the Group's Executive Committee, along with key management representation, including Investor Relations. In addition, the Audit Committee reviews disclosures relating to TCFD and climate-related emerging risks, and leads the Board in reviewing our annual reporting disclosures."*

Interviewees' comments indicated that, while most corporates have established ESG governance structures, the quality of those arrangements, as well as relevant board competencies, vary significantly. Social and governance expertise is more common than technical climate knowledge, however the awareness of the need for more technical insights on the environmental aspects is growing and companies are increasingly requesting external support on these topics. Company sector and size are also important factors, with smaller companies and companies in industries that have not yet experienced significant disruption tending to lack board-level expertise on ESG.

Remuneration

Most investors and advisors overwhelmingly endorsed the integration of ESG elements in executive remuneration, with several interviewees recognising it as best practice and increasingly supported by the investment community. Some interviewees acknowledged persisting challenges of setting ESG-linked remuneration elements, which include the availability and quality of underlying data, and difficulties converting specific ESG factors into KPIs that could form part of the compensation formula.

An alternative viewpoint, expressed by the minority of participants, suggested that specific ESG elements do not have to be included in the remuneration structure for the management pay to be impacted by the ESG performance of a company. The proposed logic is that by effectively managing ESG risks will benefit a company's long-term financial performance and disregarding them will negatively affect the performance and therefore, traditional remuneration structures will reflect that dynamic.

The quotes below represent the key views on ESG elements in senior management remuneration expressed by the financial sector representatives.

Bridget Fawcett (Citi) made a parallel between ESG elements in remuneration and the traditional structure incorporating the financial success of the company, suggesting a similar trajectory:

> *"The remuneration structure is an important component of success in terms of meeting their sustainability targets and goals. We already have a standardised approach around defining financial and operational success in a very boiled-down way, so I think we can certainly do that from a sustainability lens as well."*

Keith Tuffley (Managing Director & Vice Chairman and Global Co-Head, Sustainability & Corporate Transitions at Citi) echoed this argument:

> *"You cannot let perfection get in the way of progress, and the accounting evaluation system is inherently imperfect. We see massive movements in values and prices every single day because of these imperfections. So, we can't let that become an excuse for not embedding appropriate ESG KPIs."*

We feel that qualitative ESG elements can sometimes be used to circumvent financial metrics.

Trisha Taneja (Deutsche Bank) spoke of the importance of setting material KPIs that are linked to company strategy:

> *"Investors are clear on the benefits of tying your financial incentive to hitting sustainability targets. That is probably one of the things that are considered best practice. At the same time, KPIs have to be material, and they have to relate to your business strategy. They are not just numbers you have to hit in order to get paid, they have to be integrated into the day-to-day strategic thinking because without that your company is going to have a more expensive cost of capital or is not going to be able to access capital."*

Raine Naude (ESG Analyst, Allan Gray) highlighted the difficulties around establishing materiality and reliability of ESG metrics in remuneration:

> *"We feel that qualitative ESG elements can sometimes be used to circumvent financial metrics, and if the financial metrics are well-constructed, they should be long-term in nature and encouraged to incorporate ESG. For example, if you are losing your social license to operate, or if you are not factoring in the low-carbon transition, you are going to lose to competitors and ultimately that is going to affect your long-term cashflows. So we think that well-constructed financial*

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> *metrics incorporate ESG in terms of being long-term. If you are going to have those qualitative factors for ESG metrics, they should be material. The disclosure around those targets must be extremely transparent, and they must not be soft targets."*

She went on to specify:

> *"For example, if a company has a 60% financial and 40% ESG compensation elements, and they have not hit their financial targets, but they say that they achieved that 40% on ESG, we are not aware of how those targets were put together, and that would be a big disclaimer for us. We have to be very clear and transparent because we think that executives should only be receiving additional remuneration when they are performing above average. And if you look at some companies' ESG metrics, they can be based on a company's CDP score. But the CDP score may improve, and still be below the industry average — should they be rewarded for that?"*

The majority of companies that we spoke to integrate ESG elements into the senior management remuneration (typically the long-term incentive element), with several companies also adopting ESG elements into the remuneration structure throughout the organisation. The interviewees approached ESG-linked remuneration with the varying degree of detail, with some referring to aspirational goals and others directly linking compensation to their strategic ESG targets. The ESG-linked executive compensation element was weighted in the range between 15 to 50%. The specific ESG performance metrics commonly cited by the companies include gender and ethnic diversity and other human capital-related metrics, carbon emissions reduction, and health and safety indicators.

The following comments illustrate some of the corporates' approaches to ESG elements in remuneration and associated challenges.

Jim Burton (Grant Thornton) highlighted some of the issues that corporates face during the process of incorporating ESG elements in their remuneration:

> *"We are seeing our clients working on including sustainability metrics into their executive compensation programmes. For them, it tends to come a year or two after they started the journey, after they have identified the material topics, understood how they are going to capture and manage those items, and set appropriate targets. Once they are at that stage, 2 or 3 years down the road they might begin to incorporate them [ESG goals] into executive compensation programmes. Doing that introduces a couple of other challenges on the governance side. The governance process starts to ask more questions about the accuracy of information related to ESG elements of the remuneration package, integrity of the reporting, and assurance. It brings a whole new series of considerations from the governance perspective."*

Laurent Lhopitallier (Head of ESG Performance at Sanofi) commented on the ongoing process of establishing appropriate metrics:

> *"We are still working out targets and KPIs on different projects. Now the CEO has 15% of his variable compensation tied to ESG, and the other board members have been incentivised on diversity and inclusion, because we have strong gender parity objectives. One of the challenges around compensation is that you need something that is easy to measure with clear results. I think that is one of the reasons why carbon is working so well, because it is one of the few ESG metrics that everyone agrees on. And with gender it is the same — it is pretty straightforward to measure how many women you have been able to promote internally."*

Frank Kopfinger (LEG Immobilien) spoke of LEG's remuneration structure which is directly linked to its strategic ESG targets and is distributed throughout the company:

> *"We have a total of six ESG targets, all of them are measurable and quantifiable, and they will be audited as most of them are part of our remuneration system. Five of these targets are linked to remuneration, which is not only the management, but is also broken down into the organization."*

Jorge Collazo (Head of Investor Relations at Coca-Cola FEMSA) explains how the remuneration structure includes the adjustment of ESG KPI weightings depending on the individual's responsibilities:

> *"We include ESG-related KPIs as critical success factors for our executives. The weightings can be different, adapting to the role of each of the executives. For example, the diversity and inclusion KPI can have a bigger weight in the compensation of our HR officer, because this role is clearly intertwined with this KPI, while water stewardship would have a bigger weight in the compensation of our supply chain and engineering officer. Notably, as the methodology has an alignment factor, it accounts for the CEO's compensation as well."*

Most interviewees indicate that integrating ESG elements in executive remuneration has become the norm for many companies, as well as a standard investor expectation. At the same time, the current lack of a unified approach in evaluating ESG performance leads to persisting flaws and inconsistencies. More specifically, investors acknowledged many challenges related to data reliability, formulation of KPIs and transparency of the remuneration structures. In addition, the widely accepted link between ESG performance of a company and long-term financial returns can be used to cast doubt on the necessity of ESG-specific KPIs. Overall, this sentiment was relatively uncommon, with most stakeholders viewing ESG-linked remuneration as a necessary tool to ensure accountability and incentivise the company leadership to take action on material ESG issues.

5.0 ESG Data & Ratings

The quality and transparency of ESG data and ratings remain a contentious issue for most investors. Some of the common problems mentioned by investors were the lack of historic data, errors and evaluations made on the basis of out-of-date information, as well as the prevalent focus on disclosure rather than performance on the key ESG factors. The focus on disclosure also leads to the bias towards large capitalisation companies based in the developed markets, which leaves out investors' growing demand for greater coverage of the small and mid-size companies and the emerging markets. Finally, investor interviewees continued to raise questions around the low correlation between ESG ratings assigned by different providers and the lack of transparency with regards to the ratings' methodology.

The following quotes highlight some of the key challenges investors encounter on this topic.

Over the years we have found there can be errors in the data supplied by the external ESG data providers.

Carolina San Martin (Managing Director, Director of ESG Research, Wellington Management International) spoke about the limited quality of the external ESG data:

> *"Over the years we have found there can be errors in the data supplied by the external ESG data providers, where what the company is reporting is not accurately reflected in the third-party provider reports… that's one of the reasons why we prefer to go straight to company disclosure when we assess the ESG performance of portfolio companies."*

Raine Naude (Allan Gray) expressed concerns about the correlation between different ESG ratings and methodologies used by the providers:

> *"…to be honest, we have concerns with using third-party ratings — there has been a lot of work done by multiple organisations saying that there is a very low correlation between ratings providers. So if you are using one ratings provider to augment your ESG research, you have to be incredibly sure that their methodology aligns with the way you think about ESG, but you cannot be that sure since a lot of methodologies are proprietary. They also seem weighted towards disclosure versus performance because they are based on public disclosure, and it has been shown that companies in developed markets score higher. If anything, you want to look for companies that can improve."*

Mark Lewis (Andurand) linked the data availability challenges to the evolution of ESG data space:

> *"We have looked through all the data sources that we could use to make our own independent assessments of companies, and the key challenges were data availability and data quality. I think it is to do with the way the industry grew up — ESG was not much of thing until about 5 years ago, and they were catering to a self-selecting audience that was interested in going through a lot of indicators that did not have much impact on financial performance. Now, there is much more focus from the mainstream money managers on financial performance impact, and that is where you really want to have better data."*

David Harris (LSEG) suggested that markets are increasingly interested in the underlying data rather than a specific rating:

> *"It is important to be clear about how the data moves through the system: companies provide a lot of information in their annual and sustainability reports, then that information is collected by a variety of different data providers, analytics and index companies. That information then feeds different ESG investment datasets and indices. So the reported data is collected and goes out through various service providers. Increasingly the investor needs are less about a need for an 'overall' ESG rating, and more often about the underlying themes and data."*

In particular, investors are increasingly looking for climate-related data in order to evaluate the risks and opportunities related to the low-carbon transition and towards achieving 'net-zero':

> *"There is a particular focus on climate data, prompted by the impact that climate change is having across different industries. Investors are looking for high-quality disclosure around climate transition strategies, and often assume the worst in the absence of it. In addition, they want to see credible decarbonisation targets."*

ESG data quality and availability challenges are particularly important in the context of passive ESG investing — passive capital typically follows the index constructed by the provider and therefore relies on the providers' data and methodology, including the definition and weighting of the material ESG factors. Passive investors can meet this challenge by ensuring that their view of ESG aligns with the methodology adopted by the chosen index provider and collaborating with the provider in designing bespoke indices that are tailored to meet investors' demands. On the active side, investors have much greater freedom to supplement the ESG data that they receive with in-house research and direct engagement with companies, relying on external sources to cover blind spots in coverage or expertise.

There is much more focus from the mainstream money managers on financial performance impact, and that is where you really want to have better data.

The following quotes demonstrate some of the investor approaches to issues around ESG data:

Antonio Celeste (Head of ESG Product at Lyxor ETF) outlined the ESG data challenges in the context of passive investment processes:

> *"If you invest in a passive ETF, it will replicate a given index, so you need to understand how the index is built. This is important, because the index provider and the quality of ESG data used by that index provider will impact the quality of the ETF. As an ETF provider, it's important to select a dependable index provider and to have a deep understanding of ESG because not all ESG data providers will offer the same level of depth, and they will not use the same ESG framework. ESG index providers will use research from ESG ratings companies — MSCI, Sustainalytics, ISS-oekom, and so on. This presents two problems. First, they use different frameworks to analyse companies — for a given research provider there will be one set of indicators; for another research provider, there will be another set of indicators — the overlap between the two is not 100%, it is somewhere in the middle, around 60%. Second, the weight of a given ESG metric may vary between data providers — for example, for MSCI, a given indicator will be more material so they will assign a higher weight to it, and for Sustainalytics it will be less material, so they will it assign a lower weight. In the end, you will end up with different scores. And as a result, a company will report on a given list of indicators that would rank differently across index providers. So if there is a higher match with MSCI rather than Sustainalytics, that company will end up with a higher chance of having a higher ESG score from MSCI."*

He went on to call for greater standardisation and referred to engaging with index providers to create a more tailored product:

> *"… I'm not against the fact that there is some dispersion, because you need different views and opinions, so it is fine to have different weighting systems. But we should have the same set of indicators — this will narrow down the dispersion between different ratings agencies. In many cases, we work with index providers to design the index that we*

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> *will replicate according to our needs. They start from an off-the-shelf version, but then we tweak it, because of our specific needs, the market evolving over time, and investors having higher expectations."*

Carolina San Martin (Wellington Management International) highlighted the importance of engagement as a means to enhance the understanding of a company's ESG strategy:

> *"Engagement has been a core part of our research process for decades. It serves as an important complement to company-reported data by providing context for a company's strategy on key ESG issues and an opportunity for us to share our perspectives on issues we deem material to the long-term investment case of our portfolio companies. We have seen engagement become more of a two-way dialogue in recent years as companies are increasingly asking investors like us for our feedback. Through active ownership, we believe that we can positively influence corporate behaviour by encouraging what we consider best practices on material issues that may ultimately benefit our clients."*

One not-for-profit investor foundation spoke about using third-party research to supplement specific capabilities:

> *"In terms of our overall approach to ESG, we analyse each company and each partner's relationships with their key stakeholders, whether that be customers, suppliers, employees, or providers of long term capital. We then do a bespoke analysis for each company, which we are able to do because we have a concentrated portfolio. We don't use ESG ratings very much, but we use other external pieces of industry-specific research — we do use external sources where we think they're relevant and have that really in-depth capacity and expertise that we do not have internally."*

Despite most investors' comments on their limited use of external ESG ratings, many corporates and corporate advisors indicated that ESG ratings have significant importance. Several corporate interviewees observed that investors tend to question them on their ESG rating performance, leading them to prioritise deeper understanding of ESG ratings providers and their methodologies. While companies also note the methodological biases penalising companies in certain sectors and sizes, they also observe the improving quality of dialogue with the ESG data providers.

The following comments present some of the key observations from the corporate interviewees and advisors on this topic.

Marjorie Whittaker (Grant Thornton) noted the continuing influence of third-party ESG evaluations:

> *"We know that some of our clients' investors care about ESG ratings. We try to encourage companies to not necessarily try to chase the rating because you are just going to be in a kind of infinite spiral…but for some of them it is important — someone is waving the rating around and asking the company to do something."*

Rafaella Dortas (Head of ESG at BTG Pactual) thought that ESG ratings can be a useful barometer of the corporate communications quality:

> *"We care about the ratings providers evaluation of our ESG performance because if they are saying that we do A, and we, here at the bank, do B, we can see that we need to communicate better. And I know that investors look at these ratings, so they are important."*

Jorge Collazo (Coca-Cola FEMSA) confirmed the recurring investor interest in ESG ratings and observed the increasing quality of engagement between companies and ratings agencies:

> *"We did notice that many analysts ask questions after having looked at the analysis done by ESG data agencies and their ratings. It was important for us to increase our engagement with these ratings providers. As you know, there are many ratings providers with different approaches, and at some point, these providers and corporates were not in a conversation with one another. But what we have seen is that ESG data providers are more and more open to engage in conversations with companies and receive feedback on their analysis."*

The increasing demand for high-quality, tailored ESG data is prompting ESG data providers to evolve and innovate their suite of offerings. **Rahul Ghosh (Managing Director at Moody's ESG Solutions)** outlined how Moody's newly-created ESG Solutions Group is responding to differentiated market needs:

> *"We are seeing enormous demand and rising expectations from market participants for more transparent, granular, decision-useful ESG and climate data. There is also a strong drive for different use cases, whether that's organisations looking to understand and measure ESG performance, companies or governments seeking to finance transition plans, or investors looking to understand the financial implications of ESG considerations. Many want analytics that focus on a specific issue, such as climate change, while others seek an aggregated viewpoint. Market practitioners also want to learn how ESG tools weight human intervention and machine-driven analytical processes, and how different philosophical approaches to materiality, whether adopting a financial materiality or double materiality lens, are embedded into products. At Moody's ESG Solutions, we are developing best-in-class risk and impact analysis on ESG, climate and sustainable finance to cater to the broad spectrum of market needs."*

Alongside diverse market demands there is growing interest in ESG data on smaller companies, from capital providers, investors and corporates that want to evaluate ESG risks in their supply chains or lending and investment portfolios:

> *"We know that there is a growing focus on ESG, not just for large, listed companies, but also for smaller companies where there is less data and disclosure. Financial Institutions*

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> *want to lend to more sustainable and green companies, and SMEs make up the vast bulk of their customer base. We also see multinationals wanting to understand potential supply chain risk across their partner vendors. We have built a machine-learning, model-driven approach to assessing SME risks. We have calibrated models that contain around 140 million entities worldwide, to produce predicted metrics on around 50 different ESG issues — ranging from carbon emissions to physical risk management and other areas — based on key drivers such as company size, industry, location and adherence to sustainability commitments. Of course, these are predictive metrics, but they provide an important signal for end-users of where portfolio risks may reside and where there might be a need for additional due diligence within their supply chains or customer base."*

In the context of Moody's credit ratings, **Swami Venkataraman (Senior Vice President at Moody's Investors Service)** highlighted the importance of internal expertise and experience in mitigating the flaws of available ESG data:

> *"Our credit ratings are underpinned by both quantitative and qualitative factors. Given the very well-known shortcomings of ESG data and disclosure that exist in the market, one of the things that we found was that our own analyst judgment, in many ways, is even more important than available data. We have a global team of over 1,000 analysts, and we have been assigning credit ratings for decades. What we found is that knowledge and judgment, as well as the ability to have in-depth discussions with issuers, largely mitigated against the lack of data. In the past we didn't use the term "ESG", but our analysts have incorporated ESG issues into credit ratings for a long time and they are very comfortable in addressing those issues."*

Conclusion

Most stakeholders, including the data providers, converge on calling for disclosure standardisation as a necessary condition for material improvement of ESG data. In the current environment, active investors mitigate the limited third-party ESG information by conducting their own research and directly engaging with companies to supplement their evaluations of ESG performance, while the passive investors endeavour to work closely with the index providers to adapt the resulting product to their own requirements. Developing demand for investment products targeting specific ESG issues such as climate, low-carbon transition, biodiversity impact and others lead to the evolution of the ESG data offerings, with the data providers developing products focusing on specific aspects of ESG performance and different definitions of materiality. Interestingly, while many investors suggested that they do not tend to use third-party ESG ratings or rarely take them into account, ESG ratings retain significant importance for corporates. Several companies suggested that those ratings constitute a prominent part of their conversations with investors and lenders, as well as being one of drivers of internal accountability.

6.0 Market communications & Engagement

Corporate Reporting

KPIs

The discussion on the ESG-linked remuneration elements highlighted that establishing measurable ESG performance indicators is a key concern for companies and one which many find challenging. Finding indicators that create a clear link between ESG strategy and results can be difficult, especially in an environment with deeply embedded structures focused on short-term measurements (such as financial performance indicators). These difficulties are less prominent with regards to the climate performance metrics, which have a benefit of better developed and standardised measurement and reporting methodologies. Measurement and disclosure of social factors is significantly less advanced, which creates additional reporting challenges for corporates.

The following comments outline key corporate challenges and approaches to establishing and reporting on ESG KPIs.

Jim Burton (Grant Thornton) spoke about the inherent conflict between the existing focus on measurable short-term performance and ESG considerations:

> *"Management have a hard time connecting their actions to tangible results, so they try to look to measure those outcomes. It's not that they do not think ESG is important, but they have many other things that they are trying to manage, so when they cannot get short-term outcomes, it makes it more difficult for them to focus on those topics [ESG metrics]. Our clients tend to focus on establishing their supply chain, their customer base and product development, and now they have to manage ESG and sustainability as well. For example, they may have increased diversity in middle management, but they may not see the outcomes of that for a long time, or they have not been able to measure those outcomes. As a result, it becomes a challenge for them [management] to not feel like ESG is distracting them from other important initiatives."*

He also highlighted the difficulties of drawing parallels between traditional financial metrics and ESG performance:

> *"They [management] are used to being able to measure things like return on investment, profitability, capital expenditures. There are some ESG measures that they can start to use similarly, for example, depending on how you deal with new customer acquisition — that could be a metric you can use to determine if your ESG position is influencing new customer acquisition…but on a financial statement, it's a little bit more difficult to find a direct correlation between your action and financial results, other than the cost side of it. So we spend a lot of time trying to talk to clients about other ways in which they can measure the outcomes as opposed to just current year or short-term revenue growth."*

One way to establish meaningful and reliable social indicators is through collaboration with external stakeholders. **Mary Wroten (Director of Sustainability and ESG at Ford)** highlighted Ford's initiative of working with academia to advance disclosure on social factors:

> *"Ford has created a research partnership with the Erb Institute at the University of Michigan to define social sustainability, or what Ford refers to as 'human progress', and identify metrics to track improvements. These metrics cover key areas such as human rights, health, safety and well-being, societal good and economic prosperity. Ford's*

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> *approach has been to define goals first and then to set out the metrics required to achieve those goals. For example, pursuing the goal of preserving Human Rights required Ford to set a societal goal for the sustainable sourcing of the raw materials used in its products."*

Jonathan Vaas (Vice President of Investor Relations at Adobe) detailed Adobe's approach to social and diversity indicators:

> *"In the area of diversity and inclusion we started providing our employee diversity data in 2016, and we focused on Pay Equity, achieving what we call pay parity in the United States around 2018. We expanded that to India, and then globally, and then we announced pay parity for underrepresented minorities in the US. So we are constantly disclosing more information about our workforce, and disclosing metrics that show fairness and an aspiration of getting to fairness. Another metric that we disclose on is something called 'opportunity parity'. We want to not only have the most diverse workforce, but also make sure that people from different backgrounds have the opportunity to grow their careers and develop in a fair way. Starting a couple of years ago, we measured and published the rate at which women and men, globally, were promoted inside the company or moved to a lateral position. And last year we did the same thing with underrepresented minorities."*

Frank Kopfinger (LEG Immobilien) spoke about the established approaches to environmental and social indicators, and difficulties with creating a meaningful governance measure:

> *"It's really tough for us to come up with meaningful KPIs on the governance side. Carbon footprint is one of our key environment KPIs and we know how to calculate it. On the social side we rely on The Trust Index and we are setting up our customer satisfaction index. On the product side, the key focus is on reliability. On governance, we had a list of potential KPIs but in the end we decided that was too easy for us. I know that other companies measure numbers of work accidents, death accidents — but this is fortunately not a big issue for us since we are not a construction company."*

Investors mostly focused on environmental indicators when speaking about corporate disclosure, with several highlighting insufficient Scope 3 reporting. In addition, despite the relatively well-developed best practice and availability of guidance on carbon emissions reporting, investors observed the inconsistent quality of corporate disclosures on this topic. Increasing regulatory pressure (such as the SFDR requirements), as well as the societal shift triggered by the pandemic, drove the need for comprehensive disclosure across the range of ESG factors, including social indicators. More specifically, interviewees mentioned the lack of detailed information on diversity, including diversity indicators in different organisational sub-units, corporate culture-related indicators and health and safety measurements, such as the number of accidents. In addition, investors expressed interest in the social disclosures beyond the company's employee base — for example, indicators measuring the social impact of the company products and services. Investors operating in emerging markets highlighted the particular importance of social metrics, as well as the increased difficulties in data availability. With regards to form of communication, quantitative indicators continue being a strong preference, with some investors also highlighting the importance of qualitative disclosure.

The following comments reflect some of the key preferences on corporate ESG disclosure expressed by the investor interviewees.

Jason Mitchell (Man Group) spoke about regulation setting the direction of investors' disclosure needs:

> *"Everyone's wish list is for Scope 3 emissions disclosure that would be as accurate as possible. That would be helpful from an investor perspective, particularly under SFDR. My hopes and expectations are that companies are better able to report on social issues, particularly around incidents, especially considering the list of Principle Adverse Impact indicators that continues to grow beyond the environmental taxonomy to the social taxonomy."*

Leon Kamhi (International Business of Federated Hermes) pointed out the need for more detailed data on employees, especially with regard to diversity and culture:

> *"We would like more information on employees. At the moment, the best information we get is government-encouraged information, like the gender pay gap in the UK. With the diversity data, there is usually one indicator for the whole firm — what can be interesting when engaging with a company is what is going on in different pockets of the organisation. For example, we had much less gender diversity in the investment management teams than we might in parts of our business development teams and it's important to know that. It's also hard to gauge the morale in a firm from the outside, but we recognise that just publicising the results of the employee survey isn't necessarily going to help outsiders compare different firms' performance. So we want companies to think harder about what employee information could be useful. More granular turnover data, where you are able to say how much of that turnover was voluntary and how much of it was forced would be helpful."*

What can be interesting when engaging with a company is what is going on in different pockets of the organisation.

Roelfien Kuijpers (DWS) also emphasized the importance of corporate culture and culture-related indicators:

> *"Culture defines a company but it is difficult to measure. Most companies conduct culture surveys, measuring how motivated the employees are, how they work, and whether they are encouraged to speak up. I think more transparency on the outcomes of culture surveys is important."*

Considering the changing generational approach to work, employees' views on a company are also important:

> *"Another important factor is how committed employees are to a company. As baby boomers start to retire and millennials form the majority of any company workforce, there is a clear change of mindset — millennials are looking for positive outcomes and positive impact on the world, and when they do not see it happening they may look for other opportunities. So tracking not just employee turnover, but also employee sentiment towards a company provides a good indicator as to how well that company is doing."*

The company purpose is another important element in this context:

> *"The workforce of the future wants a specific purpose, and they want to feel good about the work that they do. For example, if you work for an oil and gas company in the middle of decarbonisation, what is the purpose of such a company? How does that company continue to send the right messages and attract people that can help it decarbonise?"*

Emanuele Fanelli (Aegon Asset Management) observed the growing need for a standardisation of social metrics:

> *"The social element has always been the weakest link because it has been the less scientific to measure and to report. The environment and climate side has quantitative indicators (such as GHG Protocol) but on the social side, apart from the obvious KPIs*

> *related to employees, Health & Safety, customer satisfaction and gender diversity, there is a massive lack of standardisation. This is due to the different regulatory frameworks of what can be disclosed in certain countries. As a global organization, we find that we cannot disclose certain social elements on a global boundary because of these regulatory challenges."*

He also pointed out the need for disclosure on the social impact of corporate business activities:

> *"What is really missing, is being able to link the social disclosures with companies' products and services — I would like to see more disclosure on the social benefits of the products and services that companies produce, and to be able to quantify and measure that, a sort of Scope 3 for Social factors."*

I would like to see more disclosure on the social benefits of the products and services.

Alex Bernhardt (Global Head of Sustainability Research, BNP Paribas) echoed the need for a greater spotlight on social elements:

> *"More focus should be paid to the social considerations. Physical climate risk is a highly tangible, globally recognised and consistently measured dynamic and, thanks to carbon pricing, it can be traded by giant corporations and as well as private individuals. The challenges are still significant but, academically, it is a far more mature area than the societal elements of ESG. This is primarily a result of the lack of consistency in the way social factors are understood, measured and disclosed. The inconsistencies and gaps in relation to social considerations present a major impediment to sustainable progress and just transition."*

Hanaa Helmy (EFG Hermes) highlighted that in certain contexts, social impact materialises over a longer time horizon, which makes measuring them more difficult:

> *"I would tell companies and investors to be patient, because you cannot measure the social in the same way that you measure other returns on investment. With the social, you must wait for the next generation to see the difference. When you work in the development field, and you work with communities, the members of the community today are not going to be the same people tomorrow, pre and post development. So, if we want a quick buck, let's forget about the social."*

Special focus: supply chains, biodiversity, corporate impact disclosure

Reporting on ESG-related supply chain information and biodiversity have been in increasing demand. Due to investor attention to these elements being a relatively recent development, reporting on supply chain and biodiversity is inconsistent and lacks established best practice.

Many investors focused on the growing awareness of the importance of biodiversity and its direct links to climate change. Some investors spoke of already engaging with companies on the related issues, including land biodiversity management and invasive species. Several corporates also spoke about setting and reporting against specific biodiversity targets, and observed an increasing amount of biodiversity-related questions that they receive from investors.

The following quotes illustrate approaches to biodiversity action and reporting as shown by some of our corporate participants.

Lucy Rodriguez (Cemex) spoke about biodiversity objectives within Cemex' company strategy:

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> *"Biodiversity conservation is one of our most relevant objectives within the environmental scope of CEMEX Sustainability strategy. We annually report our performance towards our Biodiversity targets. Some of the most significant 2020 performance highlights are that 99% of our active sites have implemented rehabilitation plans and 98% of our active quarries located in high-biodiversity values have implemented a Biodiversity Action Plan. As part of the Global Cement and Concrete Association (GCCA), we follow the "GCCA Sustainability Guidelines for Quarry Rehabilitation and Biodiversity Management" including KPIs, targets, monitoring and independent assurance."*

Deb Wasser (Etsy) spoke about addressing biodiversity concerns in the context of online commerce:

> *"Etsy believes that protecting endangered species from illegal trafficking online is an important industry issue. That is why we have long prohibited products derived from endangered species from being listed on our marketplace. Recently, we have teamed up with tech industry partners and wildlife non-government organizations to form the Global Coalition to End Wildlife Trafficking Online. With the help of the International Fund for Animal Welfare (IFAW) and World Wildlife Fund (WWF), we have been able to identify and monitor wildlife trends in our marketplace and update our policies accordingly."*

You cannot measure the social in the same way that you measure other returns on investment. With the social, you must wait for the next generation to see the difference.

Jorge Collazo (Coca-Cola FEMSA) emphasized the growing investor interest in this area:

> *"We are definitely getting more questions around biodiversity, especially in the last 24 months. Biodiversity is included in our environment priorities, specifically in the "Our Planet" pillar of our sustainability framework. For example, water replenishment programs include land compensation and reforestation, which has a key relationship with biodiversity."*

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Taskforce on Nature-Related Financial Disclosures

Several investors expressed anticipation for the increase in the availability and quality of biodiversity disclosure following the release of the framework by the Taskforce on Nature-Related Financial Disclosures. **David Craig, (TNFD Co-Chair)** provided us with a focused insight into the current landscape of financially material biodiversity information, including awareness of biodiversity risk, existing KPIs, and the expertise gap.

David emphasized that understanding of biodiversity risk is in its early stages:

> *"The awareness of biodiversity issues is high, but the understanding of the risk and where specifically the market risk sits is low. Most people are challenging and focusing on how to deal with climate change issues at the moment — very few people have a robust understanding of what biodiversity risk or nature-related risk means for their particular institution. If you take some of the major banks and corporates, right now they are thinking about how to decarbonise their lending. If you tell them — now make it nature-positive, they will look at you with an open stare — how are we going to do that?"*

He continued to highlight the need for the shared understanding of biodiversity risks:

> *"Everyone is talking about the concept of net-zero, but I think that we need to start talking about the net zero-zero-zero — not just focusing on the air, but also earth and water, with net-triple zero impact of all our activities on biodiversity. In TNFD, we talk about living nature, water, soil, air, mineral depletion, and we are developing a taxonomy around these nature-related risks, so we can at least talk in the same language. When you realise that agriculture, fishery, mining, extraction and clothes manufacturing are all, largely, dependent on nature, that is half of the world's economic output. Boards need to translate where those risks reside within their business models and understand what is happening."*

While the overall awareness of nature-related risks is low, some corporates have developed a more advanced understanding compared to the financial sector:

> *"There are many large corporates that have developed positive approaches in their areas of focus, such as Coca-Cola's work on water scarcity. But those are few, and there is a large base where there isn't enough awareness on how to understand and manage the nature dependencies on the assets that companies are using. However, I think the corporates are ahead of the financial sector — the investors are not aware of these risks and not building them into their models, this is one of the biggest issues. Also, there is very little awareness of the nature-related risks within the supply chain."*

David also spoke about some of the challenges of the present-day biodiversity data:

> *"There are a few metrics and data points out there, but they tend to be more qualitative than quantitative, and they are not comprehensive in terms of looking at nature-related risk holistically. I've heard a lot of people say that there are hundreds of databases and we just need to join them up — however having founded and built Refinitiv, the worlds largest financial and ESG data business, I don't believe that's true. There might be some specific databases around biodiversity and nature, but there is very little data that the corporates are catching that can be used to evaluate their nature-related risk. Regarding specific KPIs, water use is one — the great thing about water is that it is relatively easy to measure. If you look at FMCG companies, they already do that kind of analysis. Land use, fertiliser, oceanic pollination, species — these metrics are more complex and data will be challenging. We will need to look at not just corporate disclosures, but also satellite images and other sources of data."*

The TNFD is likely to follow the TCFD structure, but specific characteristics of nature-related risks will impact implementation:

> *"The governance framework for TNFD recycles the foundations of TCFD. Ultimately, climate and nature are very integrated, and a lot of the solutions for climate are nature-based. However, TNFD will have to be a lot more bottoms-up analysis and forum engagement. For example, geographical location makes a significant difference — with carbon emissions it doesn't matter where you emit the carbon, it has the same detrimental impact. Yet with nature-related risks, your location is very important — the amount of water you use, and how much you recycle might be a much larger issue in Northern Africa or other areas where water is scarce than it might do for example in Scotland or Norway. Another important factor which we could observe from how corporates and banks moved on climate is that it takes a few years to build up capabilities and skills in-house and through third parties. So we want to look at that capability-building much earlier, and make sure that there are people and training courses that can make that bridge between nature, risk, and finance, and join that gap because very few corporates and financial institutions have that skill set."*

Corporates must start considering nature-related risks in their supply chain as well as their business models:

> *"At the moment, a lot of biodiversity risks are overlapping with climate: natural food production, temperature increase — those areas are impacting nature. So it is not obscure to ask companies to understand how they are approaching their nature-related risks, especially where it is part of their business model. Looking down the supply chain might be more challenging because you might not always understand the business model below you. Companies would also benefit from working with TNFD and understanding the common risk taxonomy that we hope to release relatively soon."*

Considering the unequal distribution of consequences of climate change and biodiversity loss across different geographies, securing the participation of stakeholders from global jurisdictions is key:

> *"One of the things that we have to recognise is that bio and nature-related risks exist in every country and every geography, but there is a larger exposure in the Southern Hemisphere. So while a lot of our investors are based in the developed markets, where awareness of nature-related risks is higher, we are working very hard to make sure that we are not a Northern Hemisphere-related exercise, and we are incorporating firms from China, Latin America, Africa, Mexico, and other countries to make sure that we understand their issues."*

Supply chains

Addressing and reporting on environmental and social concerns within the supply chain has become crucial for corporates, as investors and regulators increasingly demand comprehensive disclosures on this topic. Several corporate interviewees spoke of the extensive supply chain governance, monitoring, and reporting arrangements that were established to satisfy these demands.

David Curran (Paul Weiss) emphasized the dangers of overlooking ESG-related risks in the supply chain and relying on entrenched organisational processes:

> *"We are seeing companies that have 400,000 suppliers, and it's virtually impossible to track each one. What these organisations can consider is creating a process that has rigorous testing, that is validated and cross-checked like financials are — there are databases that allow you to check to see who you are doing business with. For some of the largest companies in the world, 40% of their workforce are not employees — they are in the supply chain. Companies would be wise to consider who is working on their fundamental business, who is doing the accounts receivable, who is representing them in countries which could be at high risk of slavery? Modern slavery laws are not new, but they are going to be newly enforced and newly visible. You need to understand the fundamental supply chain elements of your business, and just procurement understanding is not enough. Procurement has a view of extracting the best price from suppliers, but this is not a long-term benefit for companies. Lawyers, compliance and the board can help by getting involved in the core supply system to understand where the risks are. For example, supply chains are core-coded in tech companies and banks, and we've seen fundamental challenges, such as data security issues, arising because of the problems with the supply chain."*

We are guided by the vigilance plan which sets common requirements in terms of human rights, health and safety and the environment for all supply chain entities.

The following comments highlight some of the key supply chain-related concerns and provide some examples of the measures that corporates put in place to address these concerns.

Mary Wroten (Ford) outlined their efforts to address ESG issues in their supply chain:

> *"The rise in awareness around supply chains challenges has been significant over the last 18 months. Ford's approach to sustainability in the supply chain includes a Supply Code of Conduct, which also covers carbon neutrality goals. The suppliers vary in the sophistication of their approaches to ESG, but Ford endeavours to raise the standards through initiatives such as the Responsible Business Alliance, which is the world's largest industry coalition dedicated to corporate social responsibility in global supply chains."*

Karine Fourneron (Non-Financial Reporting & SRI at Orange) illustrated ESG-related supply chain measures at Orange, which are partly driven by the domestic regulatory requirements:

> *"Our suppliers are a significant responsibility for us — we have about 55,000 active suppliers. We are guided by the vigilance plan[45] which sets common requirements in terms of human rights, health and safety and the environment for all supply chain entities. Firstly, we explain our requirements by adding a CSR clause in our contracts signed with our suppliers. It is complemented by training provided to the Orange supply chain employee. We have also teamed up with other operators to make common audits of our suppliers within the JAC ('Joint Alliance for CSR'). We built a common audit methodology — this alliance is composed of more than 15 operators — joining forces with them allows us to reach the 'rank four' of our supply chain. It allows the supplier of the supplier of the supplier of our supplier to go into the factories to check what is really done."*

45 French Duty of Vigilance Act

Monica Girardi (Global Head of Investor Relations at Enel) spoke of the approach to supply chain risk at Enel:

> *"The understanding and support of senior management is a key element of managing and containing the risks inherent in a global infrastructure like ours. We are committed to maintain high standards throughout our supply chain by requiring our suppliers to maintain best practice across human rights protection, working conditions, health and safety, and environmental concerns."*

Maurice Loosschilder (Signify) spoke about a comprehensive approach to supply chain ESG performance and monitoring at Signify:

> *"We have a Supplier Sustainability program, which includes environmental and social performance. All suppliers have to sign our SSD — Supplier Sustainability Declaration, which sets out the standards and behaviours we require from our suppliers and their suppliers. It covers labour, health & safety, environment, ethics, and management systems. In addition, we audit our risk suppliers, and they have to score at least 90 (our of 100) points in the audit, otherwise they go into an improvement track. We work with each supplier to resolve non-conformances within ninety days, otherwise we will have to stop doing business with them. For potential suppliers to continue in the qualification process, they should not have any zero-tolerance issues and score a minimum of 70 points."*

He also shared the details on the initiative to increase environmental performance transparency:

> *"We also have an environmental program where we work together with our suppliers to collect their data. And that was a big challenge — how do you get your suppliers to send you that information? To address that, we proactively initiate, develop and support carbon emission reduction activities in the supply chain through our partnership with the CDP Supply Chain program. Additionally, we incentivise our suppliers via a scoring system that rewards suppliers based on their performance against criteria linked to Signify's strategic priorities, including emission reduction activities. The better the supplier's performance, the higher it scores and the more beneficial the relationship becomes for the supplier. For example, if suppliers are filling in the CDP questionnaire, they get one bonus point, if they disclose Scope 1-2 emissions, they get two bonus points, if they sent us emission reduction activities, they get three points, if they commit to Science Based Targets or RE100 they get four bonus points. And that really made a difference, because suddenly, our suppliers started reporting. If you create a win-win, then the level of transparency in the supply chain goes up. Our supplier sustainability program plays an important role in accelerating emission reduction outside our own operational boundary, contributing to our commitment to Double the pace of the Paris Agreement."*

The understanding and support of senior management is a key element of managing and containing the risks inherent in a global infrastructure.

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Impact/SDG reporting

Most investors confirmed the importance of impact disclosure but noted the lack of established measurements and reporting approaches. In terms of investment decision-making, most investor interviewees were interested in impact data in the context of specific strategies, such as dedicated Article 9 funds or funds focusing on sustainable companies. Some of the relevant impact measurements mentioned included capital expenditure and revenues related to socially or environmentally beneficial business activities. Linking corporate activities to the Sustainable Development Goals has become a mainstay of impact reporting, however investors observed the current lack of reliable outcome-focused data in this area.

The following comments address the importance and challenges of current impact reporting practices from the investors' perspective.

In the impact investment context, **Hanaa Helmy (EFG Hermes)** highlighted that investors need to focus on the effects their portfolios are having on the intersecting environmental and social factors:

> *"Investors need to understand that the E and the S go hand in hand, and the biggest question is to how to invest to impact and improve people's lives. How much of your investments are reaching beneficiaries — women, health and education sectors? Do the investments centralise and stop at the city level, or do they go to the deep south to the communities where they are most needed? When you look at the Sustainable Development Goals, the climate change, even though it is an environmental issue, is affecting all other issues, so it is up to the investors to understand it."*

Investors need to understand that the E and the S go hand in hand.

Trisha Taneja (Deutsche Bank) emphasised that there is a growing demand for companies that can demonstrate tangible positive impact:

> *"Reporting on impact, such as, for example, green capital expenditure, is slightly different from reporting on ESG risks and material issues. From an investor perspective, there is enough demand for both. Investors want to see ESG risks, but there are particular funds, for example, Article 9 funds, that are looking to direct capital to companies that are investing in green development and increasing the percentage of revenue that comes from green products and services."*

She also observed that, despite the increasing importance of impact reporting, there is no common approach:

> *"The SDGs have become a benchmark for measuring impact — I find them too broad, but they have been used as the benchmark that investors rely on. There has been a lack of communication on what is connected to the particular SDGs — what type of activities, capital expenditures or products, but some investors depend on it."*

Leon Kamhi (International Business of Federated Hermes) provided a more positive view of the practicality of using SDG framework in corporate reporting:

> *"SDGs are useful because they offer a common language for industry, investors and governments around impact. For example, SDG performance can be expressed as the level of revenue from SDG-benefitting products i.e., how impactful a company's product and service offering is. This can be looked at over time and in comparison to its peers. Other impact measurements linked to SDGs could be around environmental performance or employee recruitment, retention and morale."*

Most corporate interviewees spoke of reporting on social and environmental impacts in some form, including linking their impact to SDGs. Several interviewees expressed concerns regarding the lack of common understanding around measuring and reporting on corporate impact, as well as SDG-linked KPIs. For some, this challenge is alleviated by the domestic regulation requirements, which require corporates to report on the external impacts of their business activities.

The following quotes demonstrate the approaches to understanding and reporting on impact adopted by some of the corporates.

Jorge Collazo spoke about Coca-Cola FEMSA's strategic approach to water stewardship in the context of corporate impact:

> *"We have to acknowledge industry impact in order to set strategic priorities. Water stewardship is a key component of our business and we have been focusing on the community's access to water and an efficient water use along our value chain. We believe in addressing the social as well as the environmental aspect. We focus on water scarcity as part of our sustainability strategy — for example, by ensuring efficient water management across our operations, but also contributing to community access to water, promoting healthy watersheds, working with the Latin American Water Fund partnership and FEMSA foundation."*

Laurent Lhopitallier (Sanofi) outlined their regulatory-led impact reporting approach:

> *"As a French company, we have been faced with a specific French regulation, called a duty of vigilance, since 2017. This regulation requires us to come up with a public vigilance plan, which shows how we address human rights, environment, and health and safety impacts within our operations and the supply chain. This vigilance plan addresses the external impact part of the double materiality. We framed this around impact parties: for example, we report on patient safety, which covers any quality side effects of the products, clinical trials, protection of personal data. On employees, we report on human rights at work, health and safety, and data protection. We consider environmental factors where they are linked to human impact — for example, the use of natural resources impacts local communities and broader supply chain. We also look at the air and water releases, and biopiracy, which is a specific concern for our sector."*

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Voluntary ESG disclosure frameworks: landscape in development

Most of the corporates that we spoke to apply several of the most prominent ESG disclosure frameworks — GRI, SASB and TCFD, with several also making CDP submissions. This broadly corresponded to the investors' views — most investors did not express an explicit preference between SASB and GRI, however many expressed appreciation for SASB's focus on financial materiality. Most investors also emphasised the importance of TCFD for climate disclosures.

On the topic of standards harmonisation, most interviewees were broadly supportive of the recent industry initiatives, including the IFRS' Sustainability Standards Board and the creation of Value Reporting Foundation. At the same time, many were sceptical about the prospect of a globally applicable framework, citing stark jurisdictional differences and significant compromises that would be necessary to achieve it.

The following comments highlight some of the interviewees' concerns around the current ESG standards harmonisation processes.

Mark Babington (Executive Director — Regulatory Standards, FRC) suggested that any global standard will have to focus on high-level rules:

> *"We are supportive of the IFRS foundation's proposals and we believe there will be a huge benefit in having global standards. One of the challenges for the foundation will be that in order to genuinely have global standards there will have to be more high-level principles because of the divergent practices, especially between the US and the EU. I assume that it will be up to individual jurisdictions to determine what additional material is needed to support the application on a country-by-country basis and deliver high quality reporting."*

Antonio Celeste (Lyxor ETF) pointed out that the reporting standards have to be broad and not focus solely on financial impact:

> *"For different stakeholders, it is important that we don't just define reporting indicators that only have a financial impact on the stock valuation. The list of indicators should be broad enough to capture the company as a whole — because there are some indicators that can be a good evaluation of company culture even if they don't have a direct impact on financial performance. The intention of providing an extensive list of indicators is good, but if there are too many standards, the companies will be lost between all of them."*

Jason Mitchell (Man Group) spoke about the challenges of the market-driven approaches and the likely continuing existence of competing frameworks:

> *"If you look at the number of companies that report according to SASB, it's now more than 1,000, and the EU effort may undermine it a bit for European companies given the recent work around the Corporate Sustainability Reporting Directive (CSRD). When we think about IFRS accounting standards, it's taken 20 years to converge around that and we still find gaps or spreads between GAAP and IFRS. Market adoption will only get you so far. We only have market-driven approaches in the US because of the lack of legislation, but if you can make the legislation work — it is there forever. I am a big fan of IFRS, I think that is the most elegant way to try and establish global standards. I feel that there will be an international sustainable standards board and accounting measure, even if the EU has its own... but there probably won't be only one, since this area is very fraught and there is a lot of competing interpretation across E, S, and G."*

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Value Reporting Foundation initiative

The recent merger between SASB and the International Integrated Reporting Council to form the Value Reporting Foundation is one of the most prominent global initiatives designed to improve the quality of ESG-related corporate disclosures. We spoke about the motivation for the merger and the purpose of the Foundation with **Bryan Esterly (the Value Reporting Foundation)**:

> *"The motivation for the merger was bringing together two complementary tools - the work produced by the IIRC, including the <IR> Framework, as well as, on the SASB side, the SASB Standards. There has been a huge call to create a more cohesive system for sustainability disclosures and overall corporate reporting, so this merger allowed us to take a big step forward in terms of the cohesiveness and effectiveness of what is available for companies to use in preparing disclosures for investors."*

Companies are encouraged to use integrated reporting and engage advisors if necessary:

> *"Companies often ask us what investors find the most useful in terms of the presentation of the disclosure, and we try to make them aware of the many available options and high-quality examples. We also encourage them to use the integrated reporting framework, because that is one of the most useful and effective ways of bringing financial reporting, sustainability reporting, and other topics relevant to corporate value into one report. We also encourage accounting and consulting firms to play an increasingly large role in advisory work and assurance around what companies are disclosing. That is perfectly consistent with our mission around how we fit into the capital markets within the existing infrastructure, existing systems that capital markets have used for a long time to support financial disclosures. We want the same kind of systems and processes to increasingly mature when it comes to sustainability disclosures."*

It can be useful to employ several disclosure frameworks, depending on the needs and interests of companies' stakeholders:

> *"We do have a view that a set of standards and a framework for investor-specific reporting for capital markets is necessary, but that doesn't contradict the need for other information that can be reported, and other frameworks that can be applied for more broad use cases beyond investors and the capital markets. In terms of communication, companies need to understand their audience and tailor their communication to that audience. We often might talk about sustainability in terms of investor needs, societal needs, or employees needs, among others, but there are varying needs and types of information or even the form of disclosures that may vary based on who the audience is — for example, a consumer company might be interested in talking about their customers and sustainability impacts of their products, which would warrant a different type of communication approach then when disclosing information to investors."*

SASB standards will continue to evolve in response to the evolution of investor demands:

> *"The level of demand and the recognition of the importance of sustainability disclosure have grown significantly. Speaking of specific sustainability issues, climate and human capital are very high on the agenda, and both of those topics are on our standard-setting agenda priorities in order to continually improve how the SASB Standards address such areas. Speaking of the <IR> Framework, what we are focusing on is improving complementarity and cohesiveness, and how SASB standards can be used by companies to fulfill the requirements and guidance provided — we think that there are a lot of complementarities today, but we also see specific opportunities to further improve the cohesiveness of how the <IR> Framework and the SASB Standards fit together."*

The Value Reporting Foundation will continue focusing on the financially material information but this is only a part of the full picture on sustainability:

> *"The Value Reporting Foundation is focused on financial materiality for the capital markets. However, it is important to say that this is necessary, but not sufficient on its own. We do not question the importance of broader societal and stakeholder needs around sustainability information, and while there is overlap, this is different from the primary role that the Value Reporting Foundation plays. We encourage the overall system to evolve and improve, we encourage various societal stakeholders to continue making progress and taking action to improve reporting and policy, and what we are focused on is squarely the capital markets, with investors as the primary audience. But we are not questioning the importance or the need for progress or improvements more broadly. Our approach with the Value Reporting Foundation is focused on what is necessary to make improvements for how the capital markets understand and use sustainability information, but this is not sufficient on its own from a global needs standpoint."*

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Disclosure vs strategic change

Finally, when discussing the current focus on the corporate ESG disclosure, several interviewees highlighted that, while high-quality ESG reporting is very important, it cannot replace the need for meaningful action. **David Curran (Paul Weiss)** highlighted the importance of the content rather than the form of disclosures:

> *"Disclosures are an output of actual decisions that companies implement, so you can only disclose what you are doing, what your results are. So instead of focusing on the wording of the disclosure, you should be focusing on the activity that drives the information for the disclosure."*

He also noted the importance of ESG-related communication that is done separately from corporate reporting:

> *"What corporates are saying on their ESG strategies, apart from their reporting, is also important — for example, what they say at Davos, what they say on the website, as well as the reports and legal disclosures. This is important because consumers do not necessarily look at the legal disclosures, but they will read the website."*

Wolfgang Kuhn (Independent Strategy Consultant, ShareAction) emphasised that the existing focus on ESG disclosure is unlikely to be effective in its aim to facilitate the capital shift needed for the transition:

> *"Transparency and better quality information is definitely a good start, but I think initiatives like TCFD have helped create this idea that if we just fix information deficits and give everyone full visibility of what companies do, then the right decisions will be made. And I do not think that would necessarily be the case, because unless you change the idea that looking after the clients is the sole job of investors, or, in the case of companies, looking after their shareholders, then not much is going to change. You make investments in companies, even if you know that there are certain risks because you get paid for that risk. And just because you know about the climate risks of an organisation, that does not necessarily mean that you are going to forego it — you might find it very attractive, and if you think that the whole climate thing is overblown, then that might make you think that certain risks are overpriced."*

Conclusion

Producing comprehensive and reliable ESG disclosure remains a difficult task for many corporates, in part due to the lack of a clear global disclosure framework that would direct companies with regards to the necessary scope, methodologies, and specific KPIs. Establishing social KPIs is especially challenging, due to the prevalent focus on environmental disclosure. At the same time, investors observed that environmental reporting is also inconsistent in content and quality, especially regarding the information on Scope 3 emissions. Corporates and investors report an increase in biodiversity-related engagement, but the understanding of biodiversity risks is still in the early stages and greater understanding of the relevant issues in their portfolios and supply chains will have to be developed.

A growing client demand for impact-focused strategies increases investor demand for corporate impact disclosure. Some of the specific impact indications mentioned by the investors include capital expenditures and revenues linked to sustainable activities. While many corporates are linking their impact reporting to SDG contributions, there is very little common practice at the moment.

Direct investor interaction

Companies observed a continuous increase in investor interest in ESG topics over the last year. Overall, the dynamic is shifting from most of the ESG-related questions being asked by specialist, sustainability-focused houses to ESG becoming a topic which is routinely raised by mainstream investors. Interviewees highlighted the growing number of ESG specialists within the investment teams, as well the noticeable shift in the role these specialists play in corporate engagements. The sophistication level of the questions is also growing, from the generic questionnaires to more targeted discussions on sector-specific ESG challenges. At the same time, this progress is inconsistent, with companies noting that some investors, being in the initial stages of ESG integration, are uncertain about which ESG topics are material to a particular business or primarily rely on third-party ESG ratings in their inquiries. Regarding the specific ESG topics that investors tend to focus on, most companies mentioned ESG disclosure, climate, and diversity on the social side.

The following quotes highlight some of the dynamics in ESG-related investor interactions, observed by the corporates.

Frank Kopfinger (LEG Immobilien) noted the dynamics of the evolution of investors' interest in ESG:

> *"There has been a dramatic shift — high-level statements on ESG were not helpful to the investor community. This was one of the reasons we came up with the ESG presentation and the framework. It was clearly helpful and appreciated. The number of specific ESG questions increased dramatically. After forming our ESG strategy, we started to make ESG-only roadshows because we wanted to talk specifically to ESG teams."*

High-level statements on ESG were not helpful to the investor community.

He also emphasised the difference in the approach depending on the resources available to investors:

> *"At the bigger institutions, the teams we are talking to are getting bigger. On the other hand, with smaller investors — they need to do everything by themselves, and they often come up with a small ESG-related questionnaire on top. The bigger institutions also tend to get deeper into the specific issues within the sector — they don't have a one-size-fits-all questionnaire, they want to discuss specific sector challenges and they want to discuss the solutions to those challenges that we can offer."*

Monica Girardi (Enel) emphasised the increasing quality of investor communications around ESG:

> *"Over the last three years we have noticed a significant increase in the sophistication of investors around the key aspects of ESG. This resulted in a more straight-forward dialogue at a more informed level, which has helped to improve investor-issuer communications."*

Laurent Lhopitallier (Sanofi) also spoke about the growing attention to ESG matters, as well as ESG ratings-related challenges:

> *"From around mid-2019, sustainability concerns started picking up on the investor side, and it has been increasing ever since. Some institutional investors have been looking at this for a long time, they have teams and a good in-house expertise. Most recently, investors from new geographies have started to ask for a specific call on ESG issues. One challenge that we have is that newcomers probably rely more on ratings agencies. At Sanofi, we aim to have a constructive dialogue with these newcomers to install a long-term engagement."*

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Jorge Collazo (Coca-Cola FEMSA) emphasised that these developments are felt beyond the European markets:

> *"The evolution of the investing community towards embracing ESG has been very fast. When I started in the IR role it was relatively uncommon to be meeting with local investors in Latin America, or even in the US, and discuss ESG during a one-on-one meeting. That has changed very fast, and today, we see local investors in Mexico with dedicated ESG teams, and almost all the time there are ESG related questions during one-on-one meetings."*

Juan Lin (Baidu) confirmed the growing interest in ESG performance and climate strategy of Chinese companies:

> *"European investors ask the most ESG-related questions. Some questions are around our 2030 carbon neutrality target, some focus on our investment approaches, and many are asking for more disclosure. Also, investors ask us about our ESG performance trajectory, because we were upgraded by MSCI twice within a year, which is uncommon — they want to understand how we achieved that. Domestic investors may not be setting out to ask ESG-related questions, but they are interested in our business development in the area of smart transportation, cloud technologies, and other activities which enable carbon emissions reduction for our customers and along the entire value chain."*

Gazprom observed an evolution in ESG-related investor interactions:

> *"Over the last few years, the level of asset managers' competence around ESG issues at Gazprom has been rising progressively. Generally, we provide investors with comprehensive responses across the spectrum of environmental and social enquiries, but we also recognise that some areas present room for improvement. One of such challenges is gender diversity within the board and senior management — we are working on it, but it will take some time to reach the levels our stakeholders want to see."*

Most investors spoke of having comprehensive approaches to corporate engagement on ESG-related issues, with many focusing on encouraging better quality disclosure in order to be able to identify the potential areas of concern. Several interviewees highlighted the importance of collective engagement initiatives, such as Climate Action 100+, which allow investors to maximise their impact in persuading companies to address specific ESG issues. Investors focused on emerging markets emphasised the need to consider the specific characteristics of their portfolio companies in the context of ESG-related engagements and allow for a more gradual improvement. In jurisdictions where the local market structures limit investor influence, government action should act as a key lever in improving corporate ESG performance.

The following quotes demonstrate the investors' perspective on the process and priorities around ESG-related direct engagement.

Antonio Celeste (Lyxor ETF) spoke about the importance of collective engagement in exerting positive influence:

> *"In our engagement activities, we are part of a consortium of investors — it is not just us doing engagement, because that is pointless. If you want to really change the management of a company, you need to put together a lot of investors. In the context of climate change, we are part of Climate Action 100+, and we have other engagement activities regarding plastic and the circular economy, one for water management, and another one for clean and responsible technologies."*

He also observed companies' growing understanding of the need to communicate with investors and improve on ESG:

> *"Even if you cannot exclude companies as a passive investor, so you do not have that weapon used by active managers, corporates today are more and more willing to cooperate and understand investors' concerns. We can't exclude a company because they are not managing a controversy as it should or it is not improving on this indicator, but because passive investment is rules-based, in the end the company will be excluded from the index if its sustainability standards are slipping. Companies are more willing to have a constructive dialogue."*

Cornette van Zyl (Investment Analyst and Associate Portfolio Manager) outlined ABSA Group's focus on engagement as a driver of change:

> *"ABSA does not have mandates that restrict investment in particular companies - as a result, fund managers can invest in companies that are exposed to ESG risks, but there is a requirement to engage with the company management to improve their ESG performance and ensure that the right initiatives are in place. This has driven a significant increase in direct engagement which in turn has created a positive real-world change in corporate behaviour."*

Nathalie Pistre (Head of Research and SRI, Ostrum Asset Management) provided an example of engagement activities encouraging corporate change:

> *"We focus on engaging with the management, giving them a clear view of the KPIs that we care about and letting them understand that if they do not act, we will eventually not be staying with that company. We do not want to adopt only an exclusion approach because we want to encourage firms to transition. The challenge is to find a good equilibrium between engaging, discussing, encouraging and, in the end, selling the position, if the company is not moving in the right direction or is moving too slowly. For example, we*

We do not want to adopt only an exclusion approach because we want to encourage firms to transition.

> *have done this with our coal policy based on the one hand on the Global Coal Exit List provided by Urgewald. Firms that are not compliant with the thresholds of this list are excluded. On the other hand we are engaging with the firms compliant with the thresholds and ask them to produce, this year, a rigorous exit timetable coherent with the "accord de Paris" . We are also working on a policy for oil and gas."*

Raine Naude (Allan Gray) emphasised the role of engagement but also observed that progress can be slow:

> *"I am a passionate environmentalist and I still believe that engagement works better than divestment. If you look at some really powerful pension funds with significant assets behind them, those companies and organisations should be engaging. Sometimes, the progress is not as quick as we would like. That is one of the big conundrums with climate change — we are being told by scientists that there is urgency, but changes are not happening quickly enough. So we have to continue to engage with companies to understand how far along they are and make sure that they are setting meaningful targets."*

Speaking of the engagement process, she highlighted climate change and their employee-centric focus:

> *"We have a company that is a substantial emitter, and we have been engaging with them for a few years, trying to make their emission reduction targets more ambitious and to get them to disclose in line with the TCFD. But we will not do that with every company, and especially companies with small market caps. In terms of other engagements, safety is very relevant for us, because we have a resource-intensive universe, so we focus on safety, negotiations, and treatment of employees. A lot of companies we are invested in have unionised employees, so we focus on those relationships. Also, community relations are important, particularly for miners in remote areas."*

Investors have significantly increased their expectations around ESG. **Rick Ogden (PAG)** provided an example of how PAG looks to drive improvements with respect to ESG in its direct lending business:

> *"We want our borrowers to engage with us on ESG. The ESG frameworks we have developed for our core strategies aim to identify areas for improvement. We are starting to document KPIs and provide economic incentives linked to improvements in performance. Our aim is to establish long term relationships with borrowers who look to us as a reliable source of capital, and we can leverage that relationship to drive positive change."*

Sometimes, the power of investors to drive companies to improve their disclosure and ESG performance is limited. **Akber Khan** spoke about structural challenges that increase the importance of measured regulatory involvement:

> *"In our region, there are a sea of companies where engagement with investors is poor or minimal. But there is now a small, but growing, group where it is world-class; the remainder fits somewhere in between. Quality and quantity of disclosure and transparency was pretty miserable a decade ago, but on average this has improved by leaps and bounds. At Al Rayan Investment we have spent the last decade pro-actively engaging with top management of listed companies, stock exchanges, regulators and major government shareholders on the importance of disclosure and communication as well as ways to improve governance. We feel it is important to remind stakeholders that a minority shareholder is part-owner of a company so must be treated as such. Many companies have been receptive but there is still a long way to go. In some countries in the region, regulators have been effective in introducing rules which have significantly improved governance — more recently they have refocused towards broader ESG adoption. As an example, when Kuwait was seeking an upgrade to emerging market status by global index providers, the exchange introduced three benchmark indices, segmenting companies partly based on their size. However, entry rules to their Premier index included a prescriptive list of disclosure requirements. Saudi had moved ahead on this several years earlier."*

Not all stakeholders had a favourable view on the effectiveness of investor engagement as a driver of corporate action. **Wolfgang Kuhn (Independent Strategy Consultant, form. ShareAction)** highlighted the problematic aspects of overreliance on engagement in the context of low carbon transition:

> *"Until very recently there was a lot of talk about stewardship and engagement, but very little happened — it was all behind closed doors so we could not measure it. If you look at proper effective engagement, I would point to ExxonMobil and Engine Number 1, where a tiny investor was able to get board members voted out within a few months. And I think that is a very interesting contrast to the normal insistence that engagement needs to be very constructive and over years. You can do it very quickly if you are clear on what you want to achieve, and that is the kind of engagement we would need to make a real change." He also suggested that engagement strategies are not likely to achieve the pace of change needed to reach the Paris targets: "If you rule out divestment, engagement is your only tool, and achieving net zero by 2050 is a pretty ambitious goal. It is clear that the economy needs to change dramatically. And so far, large companies are not changing that quickly."*

Conclusion

Regarding the dynamics of ESG-related direct engagement, companies observe continuously rising interest in their ESG performance from investors. This interest is also increasingly expressed by mainstream investors that were not considering ESG factors in the past. At the same time, as many investors start to integrate ESG in their decision-making, some lack the relevant expertise and can be excessively reliant on over-simplified information provided by ESG ratings.

The investors' perspective on direct engagement focused on the importance of disclosure. Investors also highlighted that the effectiveness of engagement can vary depending on the size of their position, which increases the importance of collective engagement initiatives. In addition, investor influence in the emerging markets can be constrained, which necessitates more active regulatory involvement in order to raise the standards of ESG performance and disclosure.

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7.0 Regulation

Ideally carbon pricing would be the centerpiece of countries' climate mitigation strategies.

IMF on carbon pricing

State-level and regulatory action is necessary to achieve the global climate targets set by the Paris Agreement. However, the existing measures adopted by countries are not enough to keep the temperature below 1.5 or 2 degrees — a stricter regime is needed to bring the global emissions down in line with the Paris trajectory. **Ian Parry (the IMF Principal Fiscal Policy Expert)** spoke about using carbon pricing as an optimal policy mechanism to achieve this goal.

Many major economies introduced measures to bring their carbon emissions in line with the Paris agreement, but significant gaps remain:

> *"On the policy front, 30 countries, including the EU, have now put national carbon pricing schemes in place. Just this year, we have seen major carbon pricing initiatives launched in Germany and in China. Canada announced that they are going to increase their carbon price to US $135 per ton by 2030 and prices in the EU trading system have risen to over US$70 per ton — so there is momentum. But there is also a huge ambition gap and a huge policy gap. Even if countries fulfilled the mitigation pledges that they made for 2030, that would only be cutting the global emissions by only two-thirds of the emission reductions that would be consistent even with a 2 degrees Celsius target, let alone 1.5 degrees. And there is a huge policy gap because to get from where we are now to where we need to be in 2030, we need to be cutting the global emissions by 25-50% below recent levels to get on track with 1.5 or 2 degrees warming. And that requires phasing in new measures over the next decade equivalent to a global carbon price exceeding $75 per ton."*

Carbon pricing is an essential instrument in facilitating decarbonisation:

> *"Ideally carbon pricing would be the centerpiece of countries' climate mitigation strategies because it provides across-the-board incentives to reduce energy use and shift towards clean energy sources. In addition, it creates a clear price signal that helps redirect new investment towards clean technology. It also mobilises a source of new revenue which might be used to fund investments for sustainable development goals or lower other burdensome taxes."*

At the same time, there are implementational drawbacks:

> *"The key challenge of carbon pricing is that it can be very difficult politically, because of the heavy burden it imposes on households and firms, as tax revenues or allowances are passed forward in the form of higher energy prices. So we think that countries should push carbon pricing as much as they can, but then reinforce it with fiscal incentives at the sectoral level, which aren't as efficient, but can still provide a powerful mitigation incentive without a significant increase in energy prices."*

As the current average carbon price ($3 per ton) is insufficient for limiting the temperature rise under 2 degrees Celsius, the IMF developed a proposal for an international carbon price floor:

> *"The Paris Agreement by itself is not going to deliver emissions reductions that we need over the next decade. An additional international mechanism is therefore needed to complement and reinforce the Paris Agreement. The international carbon price floor can provide that mechanism. There are two key elements: first, there should be a focus on a small number of large emitting countries, both to facilitate negotiation while covering the majority of global emissions. For example, if it was just China, India, the EU and the US in the agreement, that would be nearly two-thirds of the projected emissions in 2030; if we had the whole of the G20 including the EU, that would be 85% of global emissions. And the second key element to this proposal is the minimal carbon price that each participant should implement. A carbon price is an efficient and easily understood parameter and simultaneous action to scale up carbon pricing among major emitters would be the most effective way to address concerns about competitiveness and policy uncertainty in other countries."*

The carbon price floor proposal allows for flexibility to account for different levels of economic development:

> *"We think it is important to design an international carbon price floor agreement pragmatically, so first, we need to respect the principle of differentiated responsibilities of developing countries. That could be done by having stricter price floors for advanced countries, and combining this with transparent mechanisms for transferring financial and technological assistance to low income countries. Secondly, it needs to be flexibly designed to incorporate countries for whom carbon pricing is just too difficult — that can be done so long as those countries achieve equivalent emissions reductions through other policies. This price floor could be very effective — for example, if advanced countries had to meet a price floor of $75 per ton by 2030, high income emerging market economies like China — $50 per ton, and lower-income emerging economies like India — $25 per ton, that by itself would be sufficient to get the G20 emissions by 2030 in line with keeping global warming below 2 degrees — even if there were just 6 participants—Canada, China, EU, India, UK, and US—so long as all G20 countries were also meeting their Paris mitigation pledges."*

Countries taking action on their own would be far less effective:

> *"In the absence of an internationally coordinated regime, what we are likely to see is a unilateral system of border carbon adjustments — the EU has proposed phasing in a border carbon adjustment from 2023, because jurisdictions with aggressive carbon pricing, such as the EU, have to maintain their competitiveness. But such regimes are far less effective than scaling global mitigation action because they only price emissions that are embodied in traded products, which are typically well below 10% of a country's emissions."*

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Regulation and policy in facilitating low-carbon transition — market perspectives

Most private sector stakeholders had diverging views on the role of regulators and policymakers in facilitating decarbonisation, although they all agreed on the importance of regulatory action. Some focused on the need for subsidies and tax incentives in order to support sustainable sectors, while others spoke about the need to hold companies to a minimum standard on their emissions reductions. Many investor interviewees focused on the need for a mandatory standardised ESG disclosure regime. There was a lack of the general consensus on the necessity of regulatory definitions of sustainability — some argued in favour of allowing the private sector to take the lead while others thought that regulators are best placed to establish common definitions and enforce them.

When policy-makers put in place favourable incentives that drive industry development, the financial markets will follow with capital.

The following comments illustrate some stakeholders' views on the role of regulation in this context.

Nathalie Pistre (Ostrum Asset Management) spoke of the role central banks could play in facilitating the green innovation necessary for the low-carbon transition:

> *"The main challenge in terms of low carbon capital allocation is that the central banks are supposed to be neutral, which means they lend money to banks and it is for the banks to decide how to allocate that money. But this neutrality is a key reason why there is not enough money allocated to green technologies that are not yet profitable. For example, everybody wants to buy green bonds but green bonds are a very small percentage of global issuance of bonds. Why is that? It is because you need green projects, but you also need projects that are profitable for your clients and for yourself. There are a lot of innovations that are not profitable yet, so investors cannot support those projects because they are focused on the short-term profitability. I am very convinced that you need state intervention to fill those gaps. We all know that green hydrogen is not profitable yet, but we need investment to develop green hydrogen, whatever its current profitability. And we cannot ask the corporates by themselves to invest in non-profitable projects. You cannot be neutral when the situation is so urgent — and something has to change."*

Marisa Drew (Credit Suisse) spoke about the importance of the fiscal incentives:

> *"Regulators can play a huge part in establishing incentives. A good example is the solar investment tax-equity credit system in the US — almost overnight it created an entire solar industry. When policy-makers put in place favourable incentives that drive industry development, the financial markets will follow with capital, so there is a lot of power and merit in these incentives. If regulators were to redirect subsidies from polluting industries toward the green economy, the financial services industry will respond through the reallocation of capital."*

Mili Fomicov (Climate and Equity Strategy, Andurand) emphasised that ESG disclosure practice is still patchy and would benefit from regulatory mandate:

> *"We really need mandatory reporting and standardised disclosure principles, because one fund asking for something is not going to change anything. Even something as simple as Scope 1 and 2 emissions disclosure is still voluntary in most countries and there are only a few jurisdictions where reporting is mandatory. The market can provide some financial incentive to report but we absolutely need a strong regulatory framework for proper benchmarking."*

Kara Mangone (Goldman Sachs) pointed out the need for coordination across different regulatory regimes:

> *"Currently there is a wide range of ESG voluntary disclosure frameworks, ratings, and rankings, which can make it difficult for companies and investors to prioritise and compare what they need to measure and manage. As policymakers look more closely at sustainability, particularly on a global basis, we need to be mindful of not creating a patchwork of regulation that adds complexity without impact."*

Non-financial stakeholders echoed the need for a regulatory focus on incentivising climate action, improving disclosure and coordinating regulatory initiatives. For example, **Alberto Carrillo Pineda (SBTi)** focused of the importance of global alignment and policy-led disclosure incentives in the context of climate target-setting:

> *"The low-carbon transition needs to happen across all geographies and all sectors, and right now we don't have any governance mechanisms that have that global coverage. At the minimum, what we need is the incentive at the policy level for companies to disclose whether they are aligned to the climate goals that countries have set and have a reasonable level of evidence that that is the case. The other important thing is that target-setting is just one piece of the puzzle and there are many other pieces, including alignment frameworks for major investors, project finance, bonds, and what we need is the mechanism to ensure alignment between all the different initiatives of climate transition infrastructure."*

EU regime

Several financial stakeholders expressed positive views on the EU Taxonomy's role in providing clarity on sustainable economic activities, while others pointed out the need for a similar regime focusing on social factors. One distinct concern referred to the potentially restrictive definitions of environmentally sustainable activities provided in the Taxonomy. Some corporate interviewees also emphasised that the current focus on the environment penalises companies in sectors that will not be able show a significant percentage Taxonomy-aligned capital expenditure or turnover.

Some of the investors also expressed concerns with regard to the impact of the SFDR-mandated fund classification. Several interviewees pointed out that regulatory-mandated classifications can restrict investors' freedom to formulate their own views on sustainability. Others were concerned that the excessively strict definitions of sustainable investment will be detrimental to low-carbon transition by restricting the flow of capital to companies that would not currently meet these requirements but would do over time if they had access to the necessary investment. Several interviewees offered a conflicting perspective, pointing out a lack of clarity on the specific requirements of Article 8 and Article 9 funds.

The following comments illustrate the key stakeholder views on the EU Taxonomy and SFDR.

Paul Chisnall (Sustainability Director, UK Finance) suggested that inappropriately applied Taxonomy definitions might have a negative impact on the decarbonisation progress by creating an incentive to shift capital away from companies that need it to adapt to the transition:

> *"There are a lot of stakeholders that would say that investing in an oil & gas company can never be regarded as green, but we take the view that what is important is to have an orderly transition towards net-zero. In order to achieve that, we should be working*

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> *with fossil fuel companies that are trying to become the green energy companies of the future. For example, Shell and BP employ tens of thousands of people, they know all about the North Sea — very clearly, working with those companies to help them turn into green energy providers is a right thing to do. But if a bank wants to lend to those companies to help them with that transition, that would not be recognised as a sustainable activity under the EU Taxonomy. It is important to have a regulatory framework that acknowledges both aspects — selling a sustainable investment product and helping companies to transition over a longer time frame. I think that if the banks will be required to report what is Taxonomy-aligned and what is not, we will reach a point where it will be considered that Taxonomy-aligned activities are good, and non-aligned activities are not. That would create an incentive for institutions to de-risk."*

Laurent Lhopitallier (Sanofi) emphasised the deficiencies created by the omission of the social factors in the sustainability-focused regulatory regime:

> *"The Taxonomy discussions are quite tough for us because, if we are able to pull the numbers for the first part of the Taxonomy, those numbers are going to be challenging. We are in healthcare and our carbon capex and opex are very small, because it is mostly focused on real estate — compared to our R&D costs, and the overall cost base, it is barely material. So if people look at it quickly and do not think about what it means, it will look like Sanofi is not playing its part in the transition, but that is not the case — we are waiting for the social Taxonomy. Today, there is a strong premium on environment, and it is tough for our sector to play our part."*

Trisha Taneja (Deutsche Bank) spoke of the importance of providing investors with clarity while avoiding excessive prescriptiveness:

> *"By defining the terms, SFDR is providing investors with a choice, so that they know where to put their money — a carbon neutrality-aligned Article 9 fund or not. So, I think the purpose to create transparency so that people can make an informed choice was achieved. But I think that being any more prescriptive at this stage would stifle market growth, instead of helping to scale it."*

Mili Fomicov (Andurand) pointed out the danger that restrictive definitions may deprive companies that are in the process of transition of capital:

> *"I think the SFDR is a great initiative, but very rigid fund labelling can potentially lead to a bifurcated market. There are not enough green and sustainable companies to absorb the amount of capital required to participate in the energy transition. All sectors, even those with a poor starting point should be part of the solution if we want to achieve systemic decarbonisation. With transparent metrics and targets, we could invest in companies in transition and work with them on a path towards decarbonisation. Some regulatory aspects are not as dynamic and inclusive as they need to be."*

Many investors and companies reflected on the cross-jurisdictional influence of the EU sustainability regime, which is extended by some countries using the EU approach as a model for their ESG-related regulation, and European investors passing regulatory requirements down to their portfolio companies (for example, through the extended disclosure requests and/or engagement). Most evaluated this influence as positive, however some pointed towards local challenges that might need a differentiated regulatory approach.

Raine Naude (Allan Gray) spoke about the need for an approach tailored to the characteristics of a specific market:

> *"Actually, South Africa is basing a lot of its regulation on the UK and the EU, which is interesting because we are in a very different position - we have massive unemployment, big social and governance issues. Despite this, environmental regulation appears to be quite ambitious — for example, a South African draft green taxonomy, which has just been released, is closely based on the EU green finance taxonomy. The cement sector is potentially required to comply with the same level of efficiency as the EU was a bit worrying because they are asking for differentiated climate responsibilities for countries with the developing country status. I think that we still should do our part and commit to the 1.5-degree trajectory, but that would look different for us than it would for the EU industries. With regards to the principal adverse impact indicators required by the SFDR, disclosure on a lot of those is still lacking, and we would face an even greater challenge with that. The South African universe has good coverage with ESG data, but it does not equal quality because a lot of the data is missing, and if we look at Africa universes and frontier universes, it is extremely low — 25% or less. That needs to be met before investors can be regulated on disclosure."*

UK regulatory direction

Climate, as well as other environmental and social concerns have been high up on the UK's regulatory radar in the recent years. Similar to the majority of other jurisdictions, the main focus has been on disclosure, with the most prominent example being the gradual implementation of mandatory TCFD reporting across all sectors. The UK financial sector has been at the forefront of integrating climate risk considerations, guided by the PRA and the FCA.

Paul Chisnall (UK Finance) highlighted the role of regulators in steering the majority of the sector towards integrating climate concerns:

> *"From the point when TCFD issued their recommendations three or four years ago, you could see a number of banks and financial institutions starting their climate journey. But we really got traction when the PRA said that they will integrate climate responsibility into the mainstream banking supervision. From that point, the discussion was no longer*

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> *'Should we be doing this?' but more 'How do you do this?'. Before that, some smaller firms might have felt that climate risk was more relevant to the larger, global firms."*

The regulatory guidance has also played an important role in shifting a perspective on ESG:

> *"The PRA have said that they do not want institutions to define climate risk and put it into a silo — they want people to think what climate change will mean for traditional banking activities. Before this, ESG was something that a lot of firms took seriously, but they still talked about it separately, as opposed to thinking about how environmental and social factors should govern the ways you set your culture and run the firm."*

The experience of the 2008 financial crisis might have also contributed to the sector being more open to the importance of non-financial considerations:

> *"It might be that the financial services firms, having been through the financial crisis, eventually developed an understanding that many of the problems were conduct-related. They began to see that they were suffering huge existential losses within the system, not just because of getting the financial metrics wrong, but because of the corporate culture and conduct. That realisation prompted an openness to the idea of a culture reset and a greater willingness to think about what it means on the executive level."*

FRC

The Financial Reporting Council (FRC), an independent regulatory body responsible for audit and accountancy oversight and the corporate governance standards, has also joined the efforts to embed ESG across the UK regulatory structures. In the recently published Statement of Intent, the FRC outlined their views on the key ESG challenges and the necessary action. We spoke to **Mark Babington (Executive Director — Regulatory Standards, FRC)** about the regulatory perspective on the topic of decision-useful ESG data.

The provision of high-quality, reliable ESG information is a priority for the FRC:

> *"We focus on the provision of high-quality information for decision-making, and part of that role is to help provide transparency so that investors and other stakeholders can decide whether companies are meeting their ambition to take steps to deal with the impact of climate change. This task poses certain challenges — for example, the information that people have to work with might not have the maturity of financial information. To report high-quality information, you need to have data systems and data itself that are sufficiently mature to support reporting and assurance. In addition, transition to the low-carbon economy is something that happens over the medium term, and so we are not just looking at a snapshot, we are looking at progress, a long journey that is going to take many years. Therefore, information that is provided to stakeholders has to be reliable for them to make an assessment of how well those entities are progressing down that decarbonisation route."*

Strengthening assurance practices around ESG data can play an important part in improving reliability:

> *"Reasonable assurance would give users of that information much more certainty that the information they are using is reliable. We will have to think about what assurance standards might be required, we have ISAE (UK) 3000, which is an assurance standard for information that is not historical financial information, and that is an effective route for that work. But the challenge is that it needs to be made more specific for different types of information. There is an interesting piece of work that IAASB carried out with the guidance on emerging forms of external reporting, looking at how you could provide an assurance framework around that. I suspect as this develops, you might want to look at how we fill that gap and ensure consistency."*

It is important to ensure the consistency of reporting information across the ESG spectrum:

> *"When the IFRS foundation said that it was looking to develop global standards, one of the things that were commented on by IOSCO was the need for a consistent conceptual framework that would be aligned with financial reporting. Although people are very passionate and very focused on climate and environmental reporting, it is really important that social and governance reporting fit within the conceptual framework, so that you do not have different frameworks that apply to different types of information. Therefore, some of the things that I would be keen to do is to engage to ensure that there is some consistency in the conceptual framework for that information so that it doesn't develop in different ways. That would not be helpful in creating a single and consistent information set that would give an understanding to what an entity is doing, what its activities are, how effective it is being."*

Another concern is varying levels of disclosure quality depending on the companies' level of sophistication in dealing with multiple sets of reporting requirements:

> *"There is a proliferation of new requirements, but we have to make sure they all fit together. You do not want companies to be confused about what their reporting obligations are, and as a result, failing to do an effective job. And we want high-quality consistent reporting across the marketplace, we do not want it to become a two or three-tier market where there are some who can report effectively while others struggle. The landscape will have to develop to reflect that, and I think we will probably see a growing demand for guidance, because when government legislates for some of these reporting requirements, the legislation will probably be quite high-level, so to turn that into meaningful information there will be a need for more detailed guidance to support reporters."*

Coordination of regulatory action on the domestic and global levels is a necessity, but it brings its challenges:

> *"Reporting of information happens at the global level, and we need to make sure that we have the means of reporting that is consistent and useful in that global context. We are very supportive of the IFRS foundation's proposals and we believe there is a huge benefit in having global standards. One of the challenges for this will be that, in order to genuinely have global standards, they will have to be more high-level principles because there are divergent practices, especially between the US and the EU. Then, it will be up to individual jurisdictions to determine what additional material is needed to support the application on a country-by-country basis."*

Regulatory coordination and jurisdictional challenges

Most stakeholders emphasised the need for global harmonisation on rules around climate action and ESG. At the same time, many spoke of significant obstacles to cooperation efforts, ranging from differences in the regulatory environment, to the political climate and the levels of economic development.

Ian Parry (IMF) highlighted that the need for global cooperation between many different parties is a significant challenge to climate action due to the many competing interests and concerns that prevent the adoption of effective measures:

> *"One key obstacle to scaling up global mitigation ambition under the Paris Agreement alone is that there are just too many parties involved, negotiating over too many parameters. In addition, it is too difficult for countries, when they act unilaterally, to aggressively scale up mitigation policies due to concerns about the impact on their competitiveness and there is uncertainty about what other countries will do — whether they will fulfill their pledges and what policy instruments they will use."*

One key obstacle to scaling up global mitigation ambition under the Paris Agreement alone is that there are just too many parties involved.

Focusing on the world's largest emitters reduces the number of parties involved in negotiations, but many challenges remain. Ian emphasised that countries could gain significant advantages from choosing a more proactive approach to carbon price increases:

> *"On one hand, it's transparent that the climate is changing more quickly than we anticipated, and that is galvanising concerns. In addition, there is a growing appreciation that just relying on the Paris Agreement itself is not going to deliver what we need — if we do nothing else, by 2030 it's going to be too late to achieve these temperature goals. So it is up to those large emitters — it is not in their interests to lock in dangerous levels of global warming because China and India in particular are very vulnerable to climate change. From the perspective of self-interest and wanting to lead the world to an agreement where we can solve this problem, they should be interested in international cooperation. India has not contributed much to emissions historically, and they have low per capita emissions, and that is why we suggest a stricter regime for developed countries. In addition, this is an opportunity to set up a transparent and robust source of climate finance — India, as part of this agreement could negotiate an annual flow of finance to help with its clean energy transition. China is reluctant to join an international regime that commits them to specific targets, but on the other hand, they are serious about their clean energy transition and they plan to extend their pricing scheme to the industrial sector. Joining an international regime where all big emitters are acting together on carbon pricing will help China to aggressively scale up their own carbon pricing. For the US, carbon pricing is challenging for political reasons and it is difficult for the US to push for a carbon price floor when they don't have a carbon price themselves."*

When discussing country-specific challenges to developing ESG regulatory regimes most private sector stakeholders focused on ESG disclosure.

David Curran (Paul Weiss) suggested that the US is on the brink of a major shift in terms of regulatory focus on ESG issues, which is going to be challenging for companies that have not been paying attention to their disclosure practices:

> *"With the new Biden administration there is not just a lot of focus on climate, but also the 'S' category — diversity, equity, and inclusion is notoriously porous in terms of data and clarity. It is going to be interesting for companies to deal with, because if there is going to be an increasing focus on transparency in climate and diversity disclosures, the regulators are going to look back at the decisions that companies made prior to that rulemaking. That is going to be a challenge, because many companies have been working under the idea that they did not need to disclose anything."*

Jim Burton (Grant Thornton) highlighted potential liabilities arising from ESG disclosure as one of the difficulties facing the US market in the drive for better ESG reporting:

> *"The regulatory environment around the globe is so different in terms of corporate accountability and responsibility, from a litigation perspective, that it is going to be very difficult to try to find a global expectation that works everywhere. The real challenge for the US regulatory environment is going to be the liabilities associated with the disclosures. Markets and businesses go up and down, there are going to be people who profit and people who lose at various times, and with the very litigious environment that we have in the US, it is going to be interesting to see how ESG-related disclosures start to play into that. There is no well-understood preference or a doctrine as to how entities and boards are responsible for issues or misstatements that arise from ESG and sustainability disclosures. I think everyone agrees that corporations and entities should not be absolved completely from any responsibility for accurate reporting, but it is important to understand that if they set a net-zero goal for 2040 — what does that mean for the next 15 years? And since I am taking actions and making efforts, how can somebody claim that a gain or a loss associated with my disclosures and affected their investment decision when it's such a long-term horizon."*

Akber Khan (Al Rayan Investment) spoke about the disclosure-related developments in the Middle East, and the obstacles presented by the structure of the local economy:

> *"Within the region, the Qatar and Saudi stock exchanges have been at the forefront of pushing for ESG disclosure. A voluntary framework exists in Qatar and we are hopeful that it will soon become mandatory. But in some markets this is being adopted bottom-up rather than top-down."*

The significant importance of fossil fuels to the local economy weakens the incentive to take decisive climate action:

> *"Across the region, it may be hard for governments to outline aggressive cuts in carbon emissions when they are the biggest emitters in their countries. So in the near term, the focus will be on a host of measures to offset emissions and improve production and distribution efficiency. For example, most national energy companies have set progressive targets to reduce flaring which cuts waste and carbon emissions."*

Conclusion

There is an apparent need for coordinated global action across the spectrum of regulatory and market-based measures to curb carbon emissions to an extent necessary to observe the targets set by the Paris Agreement. Most stakeholders, public and private, recognise the urgency and the need for decisive action. At the same time, interviewees' views significantly diverged on the specifics around the regulatory measures needed.

Many private sector stakeholders focused on the need for high-quality ESG disclosure, which is also one of the key priority areas for regulators in many jurisdictions, including the UK, EU, and increasingly, the US. Several interviewees emphasised the need for the global harmonisation of the ESG disclosure regimes with several pointing out the existing obstacles preventing this development.

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Most stakeholders in the public and private sectors welcomed the EU sustainability regime, including the Taxonomy and SFDR, and acknowledged the EU's leading role in establishing best practice on ESG regulatory frameworks. Several interviewees saw the current focus on the environmental considerations as a significant drawback of the regime due to the omission of companies in a number of sectors. Many investors expressed conflicting opinions on the effects of the SFRD — while some saw the fund classification as potentially too restrictive, others viewed the definitions as vague.

The US interviewees observed the growing regulatory attention to ESG reporting, which is expected to result in tightening requirements with regard to the environmental and social elements. Several stakeholders based in the emerging markets highlighted the slower pace of development of ESG-related regulatory mechanisms, due to the country-specific constraints.

The vast majority of industries are in transition today.

8.0 Access to capital

The accelerating pace of transition towards the low carbon economy and the increasing integration of ESG factors into the investment process creates additional risks and opportunities for companies in terms of their ability to attract capital. On the risk side, negative ESG performance is already impacting the ability of companies to attract and retain investors although this is currently most relevant to companies in the fossil fuel-centric industries. Not all investors take an exclusionary approach to these sectors, but the ones willing to provide capital to the heavy emitters are increasingly expecting these companies to commit to material improvements of their ESG performance.

The following comments illustrate the stakeholders' views on the influence of ESG performance on corporate access to capital.

Swami Venkataraman (Moody's Investors Service) spoke of the challenges faced by the energy sector:

> *"We have seen the coal industry being significantly affected by the rising cost of capital. Coal companies either have difficulty raising capital, or they can raise capital but at a much higher cost because the pool of investors who are willing to invest in the industry has diminished. We are now beginning to see that trend spread to the oil and gas industry, where some banks are not as willing to lend to that industry as they were in the past. Their working capital consortia of banks are narrowing. Bond investors are also staying away from certain types of bond issuances from issuers in carbon-intensive sectors."*

Marisa Drew (Credit Suisse) emphasised the need for gradual transition arrangements that provide clear incentives for companies to improve their performance:

> *"I would make the distinction between those sectors that truly do not have a reason to exist in the intermediate term because there is a viable, sustainable substitute at scale — there a harder line is critical. But the vast majority of industries are in transition today, and we must be in a position where we use our ability as a financial institution to finance and advise those companies on the transition. This is trickier for oil and gas companies. If you just shutter them immediately, as some people propose, most of the world will be without heat or electricity, and we would have a catastrophic economic and social problem. There must be a transition period while we scale up the green alternatives. Our role is to help those clients evolve quickly while we also finance the emerging green breakthrough technologies."*

She also illustrated how this shift is reflected in Credit Suisse's lending decisions:

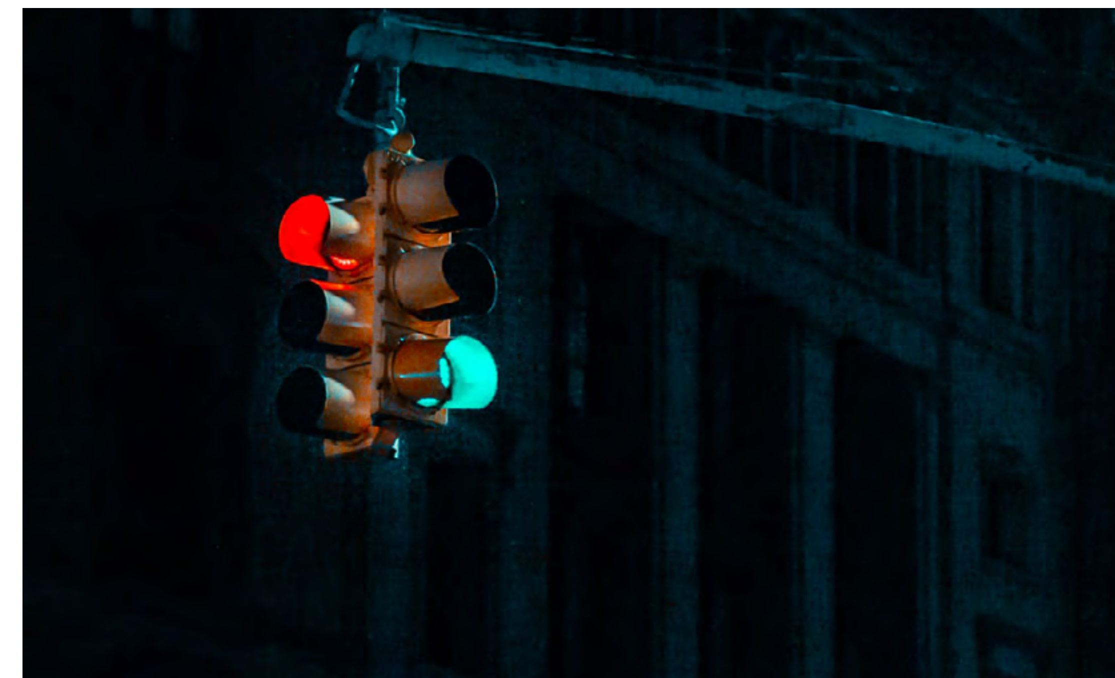
> *"In our investment bank we have mapped out our loan exposures along a spectrum from unaware (clients that do not intend to change) all the way through to the most progressive, and we want to rotate our lending book to those clients who really want to change. But for the clients who are not willing to migrate toward sustainability we will, over time, not be in a position to renew that capital."*

On the beneficial side, these developments open additional funding opportunities for companies that can show a positive trajectory in their ESG performance. The investors' demand for sustainable companies is fragmented between businesses that show best-in-class ESG metrics, companies providing specific solutions to the current environmental or social challenges, or companies on a transition path. These dynamics exist for equity and debt financing, with several interviewees remarking on a significant recent growth of the green bond market. Corporate interviewees that have engaged in green bond issuances also observed that investor demand has exceeded their expectations.

The following comments highlight the growing investment opportunities available to corporates with a differentiated ESG approach.

Rahul Ghosh (Moody's ESG Solutions) spoke of the debt investors' growing interest in companies' ESG performance:

> *"Issuers will optimise their ability to access capital markets if they have a coherent ESG plan and credible sustainability objectives. We are already seeing that in the broader thematic-labelled bond space. Indeed, the rise of sustainability-linked bonds (SLBs) this year has attracted the attention of issuers and investors alike. We saw $31 billion of issuance of SLBs in Q2 2021, from less than $10 billion of issuance in the whole of 2020. There are, of course, long-term challenges for SLBs in terms of the robustness of KPIs and sustainability performance targets. Nonetheless, the growth of this market clearly shows that investors want to better understand how a company is positioning and preparing itself for material ESG risks and opportunities in the future."*



Claire Dorrian (Head of Sustainable Finance, Capital Markets at LSEG) highlighted the continuous innovation in the sustainable bond landscape:

> *"Recently we have seen an increase in issuances and demand for social bonds, in response to the pandemic. As part of our efforts to drive climate change action, this year we launched a dedicated transition bond segment as part of the sustainable bond market. This segment will display debt instruments from issuers who have a corporate strategy or transition framework that is aligned to the Paris Agreement, including approved targets to achieve net zero and discloses, manages and addresses climate-related risks in line with global standards such as the Climate Transition Finance Handbook, the CBI transition Certification Framework and the Transition Pathway Initiative."*

David Curran (Paul Weiss) emphasised the growing opportunities for companies that are able to demonstrate their ESG performance:

> *"I have talked to many impact investors and there are simply not enough green or ESG-friendly investments out there, so there are trillions of dollars on the sidelines, looking for a port. If you can differentiate your ESG performance from the competition you will attract some of that money. We are seeing many early-stage companies contacted by investors just because they are green ports."*

Conclusion

While ESG-linked investment strategies still lack common approaches and criteria, the stakeholders are starting to see the reflection of the ESG focus on capital provision. This is expressed in the growing funding difficulties experienced by fossil fuel-intensive industries and the correspondingly increasing opportunities for companies that can differentiate their ESG strategy. Stakeholders observed this dynamic across equity (public and private), debt and lending funding channels.

Ongoing ESG Thought Leadership

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