Building a better working world

How will ESG performance shape your future?

Why investors are making ESG an imperative for COVID-19 and beyond

Climate Change and Sustainability Services (CCaSS)
Fifth global institutional investor survey

July 2020

The better the question. The better the answer.
The better the world works.

Contents

Foreword

The latest EY investor survey comes at a time when the rules for capital markets are being rewritten. As the social and economic impacts of the COVID-19 pandemic continue to play out on the global stage, we are left wondering how investors will direct capital to support economic recovery. For me, at least, the question of the relevance and importance of environmental, social and governance (ESG) factors to that audience has never been more pressing. I am pleased, therefore to be able to introduce this fifth edition of EY research into investor perspectives on ESG performance and the central role it plays in their decision-making and long-term investment management.

This year's study was undertaken as the COVID-19 pandemic and subsequent measures started to have a global impact. It reveals that institutional investors are raising the stakes when it comes to assessing company performance using ESG factors. Where some may have questioned whether investors would retreat to short-term performance models, the research suggests that that ESG has never been more important. Indeed, the majority are signaling a move to a more disciplined and rigorous approach to evaluating corporates' nonfinancial performance.

Continued gaps in expectations between issuers and investors are a significant concern, given how fundamental nonfinancial performance is to investment decisions. All investors in our research say that ESG information plays a pivotal role in decision-making, but a significantly higher number this year say their investment direction is more frequently influenced by it. Given this shift, there is a more pressing need for investors to have confidence and trust in the credibility of information on nonfinancial performance. We found strong investor appetite for ensuring that ESG disclosures are underpinned by appropriate structures, reviews and controls.

In what is fast becoming a critical decade for us all to address urgent environmental and climate change threats, and while society and the economy are still reeling from the COVID-19 pandemic, these issues are even more important. Although many organizations are in crisis-response mode, wider ESG issues remain critical and are essential to resilience, long-term recovery and driving a genuine sustainability agenda.

In fact, I believe that organizations with strong sustainability functions will be more likely to rebound once the crisis is over and deliver long-term value. Businesses that consider what is most material to their organization's long-term success, and take a macro view of emerging megatrends, will likely be better equipped to respond to the societal upheaval and anxiety caused by systemic issues such as pandemics and climate change. This is supported by the EY *Megatrends 2020 report*[1], which highlights the importance of taking a future-back approach. By creating multiple future scenarios, businesses can help to reframe their future and capture new growth alongside the development of business models to deliver long-term value.

This is echoed in the market, where research has shown that climate-focused stocks outperformed others between the start of the crisis and through the major period of market volatility in Q1 2020[2]. And, as we move into the long-term recovery stage, we will likely find that consumers and employees have very different expectations and behaviors. This change in consumer behavior has already been tracked in the *EY Future Consumer Index*[3], which found that one third of consumers surveyed said their choices would be guided by their environmental and social concerns.

I would like to extend my thanks to the nearly 300 institutional investors that participated in this year's research. As all of us are aware, we are at a critical point in our history; careful stewardship of people, environment and resources has never been more important.

Mathew Nelson
EY Global CCaSS Leader

1 "Are you reframing your future or is the future reframing you?" EYGM Limited, 2020
2 "ESG Stocks Did Best in COVID-19 Slump, Insights, HSBC." Global Banking and Markets, https://www.gbm.hsbc.com/insights/global-research/esg-stocks-did-best-in-corona-slump, HSBC, Paun, Ashim. 27 Mar. 2020.
3 "Future Consumer Index: As consumers keep adapting, how will your business keep changing with them?, EYGM Limited, 2020.

Executive summary

Investors raise the ESG stakes

This year's research finds that investors are stepping up the game when it comes to assessing the performance of companies using nonfinancial factors. Overall, 98% of investors surveyed evaluate nonfinancial performance based on corporate disclosures, with 72% saying they conduct a structured, methodical evaluation. This is a major leap forward from the 32% who said they used a structured approach in 2018. When this research series began back in 2013, more than a third of investors said that they conducted "little or no review of nonfinancial disclosures." This cohort has dropped significantly over the years, to the extent that it represented just seven of the investors surveyed this year (see figure 1).

Investors are also building their understanding of the ESG reporting universe, factoring in disclosures made as part of the Task Force on Climate-related Financial Disclosures (TCFD) framework. In fact, this research found strong evidence that investors see the TCFD framework as a very valuable approach for wider nonfinancial disclosures, beyond climate-related information. And, as they look to build insight into long-term value, investors expressed a strong desire for a formal framework for measuring and communicating intangible value, and a closer connection between mainstream financial and ESG reporting.

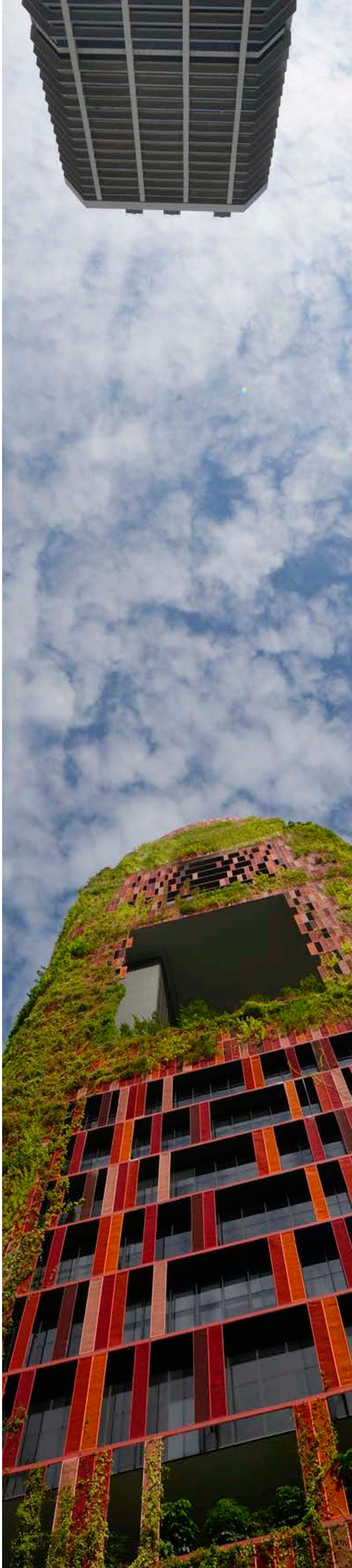
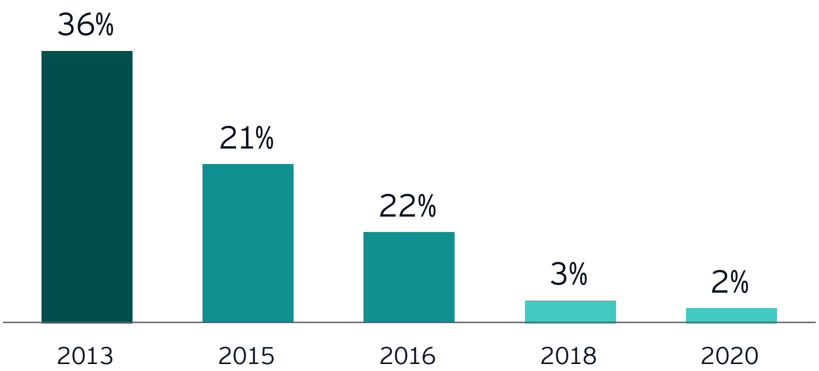


Figure 1: Very few investors do not conduct a detailed review of nonfinancial disclosures

Which of the following statements best describes how you and your investment team evaluate nonfinancial disclosures that relate to the environmental and social aspects of a company's performance?

Percentage of respondents who say they conduct little or no review of nonfinancial disclosures



The ESG performance disconnect: environmental risk in the spotlight

For formal evaluation of ESG performance to be more effective, investors need more standardized and rigorous nonfinancial data from corporates to support their approach. However, investor dissatisfaction with the information they receive on ESG risks has increased since 2018: for example, the number of investors that are dissatisfied with environmental risk disclosures has increased 14 percentage points since 2018. This is a concern, given the focus investors are placing on robust environmental risk insights. This appetite is reflected in the fact that investors identify the climate-focused TCFD framework as the most valuable way that companies can report their nonfinancial performance. However, more must be done to meet this need for environmental risk insight. In particular, investors surveyed feel more should be done by corporates to provide robust insight into how they identify, assess and manage key climate and other ESG risks.

Investors are holding companies accountable

The importance of strong alignment between corporates and investors is reinforced by the central and decisive role that ESG plays in investment decisions: 91% of investors surveyed say that nonfinancial performance has played a pivotal role in their investment decision-making over the past 12 months, either frequently or occasionally. And, the proportion of investors that say this happens frequently jumped to 43% from 34% in 2018. Climate risk in particular plays a significant part in decision-making: 73% of investors surveyed say they will devote considerable time and attention to evaluating the physical risk implications of climate change when they make asset allocation and selection decisions; 71% say the same of the transitionary risks due to climate change. A significant number of investors surveyed are also making extensive use of exclusionary screening, with positive screening of growing importance in sustainable investment decision-making.

The future of ESG performance: trusted and credible

Credible information strengthens confidence in companies and markets. Investors need ESG disclosures that are clear and transparent, founded on high-quality data, and produced using robust and reliable processes and systems. The research found significant appetite from investors for an independent lens on ESG performance. For example, 75% said they would find value in assurance of the robustness of an organization's planning for climate risks. They also see a strong need to build confidence and trust in green investment disclosures, with 82% saying it would be useful to have independent assurance of the impact of green investments.

What next?

Action in three areas is suggested for companies to meet the expectations of investors and ensure their ESG performance plays a critical role in a crisis-hit world:

- First, build a stronger connection between nonfinancial and financial performance. Investors can focus on building more credible and nuanced approaches to understanding what influences long-term value for certain sectors and companies, while corporates themselves can focus more on their materiality — reporting on what environmental, social and economic factors are most relevant to their stakeholders and could impact their ability to create value over the longer term.
- Second, build a more robust approach to analyzing the risks and opportunities from climate change and the transition to a decarbonized future, and communicate this more comprehensively through TCFD reporting. Critical actions range from understanding the resilience of business strategies and assets under a range of possible climate scenarios, to assessing avenues for capitalizing on the economic opportunities of a decarbonized future – including attracting and accessing capital.
- Third, instill discipline into nonfinancial reporting processes and controls to build confidence and trust. Establishing effective governance practices and seeking independent assurance of nonfinancial processes, controls and data outputs can help build trust and transparency with investors. This is an area where CFOs and their finance teams — which have extensive experience in establishing processes, controls and assurance of financial information — can bring their best practices and experience to bear. The input of CROs and risk teams can also be valuable, as can treasury function input when green finance is involved.

1 | Investors raise the ESG stakes

> “It is our conviction that companies that perform well on ESG are generally less risky, better positioned for the long term, and possibly better prepared for uncertainty.
>
> **Vincent Triesschijn**
> Director Sustainable Investing, ABN AMRO

Most investors are moving toward more rigorous ESG evaluation

This is a critical time for ESG. As part of the recovery from the COVID-19 pandemic, capital markets are reflecting on the potent impact that environmental disruption can have. Despite “infectious diseases” featuring in the top 10 risks of the World Economic Forum’s *Global Risks Report 2020* (published on 15 January 2020[4]) in terms of "impact", it did not meet the same list for “likelihood.” This failure to consider environmental and social risks adequately due either to their perceived longer-term impacts or the reduced likelihood of occurrence, has left many wondering how well prepared capital markets are for such shocks. At the same time that society and regulators alike are looking to corporates to play a leading role in rebuilding our global economies, investors are increasingly asking whether risks such as climate change will be adequately addressed. According to some, this presents an opportunity to rebuild a more sustainable, decarbonized economy.

Adrie Heinsbroek – Principal, Responsible Investment, NN Investment Partners, the stand-alone asset manager of NN Group, the biggest Dutch life insurance company – posits that, while the COVID-19 pandemic might prove a short-term distraction from other societal challenges, ESG performance remains critical to drive long-term resilience and a sustainable, prosperous future. “COVID-19 discussions may shift a little bit of attention away from other long-standing issues that we need to solve as a society, like climate change and water distress, as people focus on the survival of the economy,” he says. “But we should try and make use of this opportunity to build back better – making the economy even stronger and more sustainable in the future. And that will probably help us to future-proof and be resilient in the face of any other destructive pandemics or other issues.”

Mary Delahunty, Head of Impact at HESTA, the Australian superannuation fund for the health and community sector, also believes that, while the pandemic has taken attention away from other societal challenges in the short term, it is crucial to how corporates respond. “COVID-19 has meant some of the immediacy of the climate emergency is not front of mind for some, because the voices of those advocating change are somewhat lost in the emergency response,” she says. “But how companies respond quickly to the pandemic – addressing the risks and thinking about them strategically – is exactly the way they need to respond to climate, governance and social risks. Early in the pandemic, we worked through our active engagement or ownership to set principles for the immediate actions we wanted to see from companies. The ‘S’ in ESG is vital in managing this crisis and how companies demonstrate their responsibilities through their behavior.”

4 “Global Risks Report 2020 – Reports – World Economic Forum.” Global Risks Report 2020, http://reports.weforum.org/global-risks-report-2020/shareable-infographics/. 29 May 2020

The COVID-19 pandemic underscores the importance of the "Social" in ESG and the need for more robust disclosures

According to a vice president responsible for ESG investment at a major North American asset manager, today's pandemic situation underscores the importance of the social dimension of ESG. "I think what this crisis has done is shed a light on the importance of the human capital dimension of ESG," they told us. "This is something that the ESG community has been talking about a lot, but which maybe hasn't risen to the top of people's agendas. There's been a lot of focus on climate change – and that will continue, given it's a long-term systemic risk that could have similar impacts to COVID-19 in the long term – but I think there's been a real lack of disclosure on the human capital side."

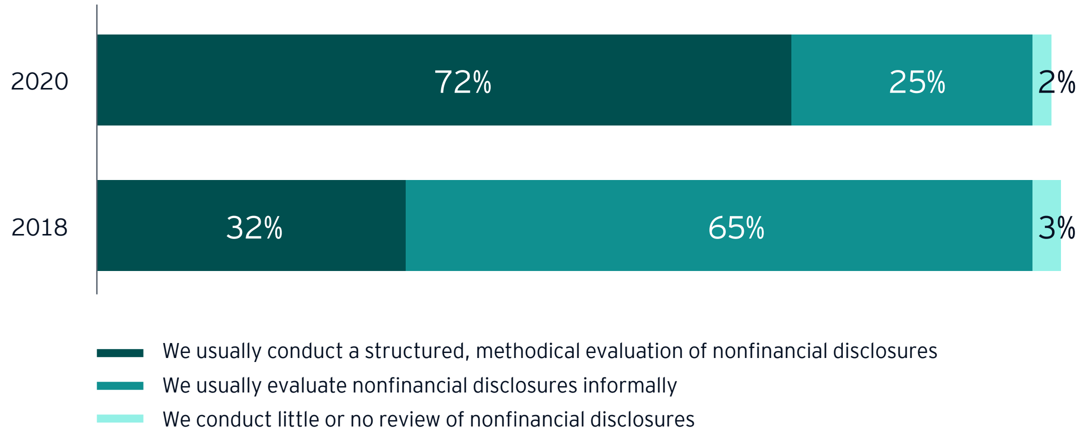
"It's something that we have discussed in consultation with regulators, especially in North America, around the need for companies to really give us more disclosure around human capital. While so many companies say employees are their biggest asset, it's really been hard to measure that. A good example is that, often, basic turnover rates are just not disclosed. There's a lot of rhetoric around employees and human capital, but COVID-19 has really put that under the spotlight in terms of how companies are addressing this issue with their employees and making the tough decisions they need to reach."

In this environment, the scrutiny of ESG factors is high, and capital market sentiment and practices have changed significantly. This study – the fifth research report over the past seven years – finds that investors surveyed are stepping up the game when it comes to assessing the performance of companies using ESG or nonfinancial factors. Overall, 98% of investors surveyed evaluate nonfinancial disclosures, either formally or informally.[5]

The research is also showing a major commitment from investors to move to more rigorous evaluation. Today, 72% of investors surveyed say they conduct a structured, methodical evaluation of nonfinancial disclosures – a significant jump from the 32% who said they used a structured approach in 2018 (see figure 2). Moreover, many of those who currently use an informal approach plan to move to a more rigorous regime: much more than a third (39%) say they will move to a more formalized approach over the next two years.

Figure 2: The vast majority of investors say they usually conduct a structured and formal review of ESG disclosures

Which of the following statements best describes how you and your investment team evaluate nonfinancial disclosures that relate to the environmental and social aspects of a company's performance?



[5] Note: Due to rounding, the numbers presented throughout this report may not add up exactly to the totals provided, and percentages may not reflect the absolute figures precisely. Throughout this report, "0%" and "zero" refer to a numerical value between 0 and 0.5.

For Jacob Michaelsen, Head of Sustainable Finance Advisory at Nordea, this trend reflects a wider shift in philosophy from both companies and investors. "On the corporate side, over the last 10 years or so, sustainability has moved from the fringes into the core of the business," he says. "It's extended from the communication or investor relations team into operations and strategy. And that is also now happening more generally with investors, and especially fund managers. While it is certainly true that some of the more advanced investors have worked with this for a long time, I think it is fair to say that, broadly, the focus has been more on 'socially responsible investment' that, to a large extent, has relied on exclusions as the main tool. However, today, sustainability is fundamental to how we in financial markets need to undertake our investment analysis going forward. Investors are recognizing that and saying, 'this needs to be fundamental to our entire investment strategy.'"

ABN AMRO's Vincent Triesschijn also sees ESG having moved from a specialist area to a place at the heart of investing. "Within our firm, ESG investing grew from a niche strategy to mainstream investing today. In all our investing activities, ESG takes a prominent role in the investment process and in eventual decisions to invest in a company. In total we rate over 10,000 companies and more than two million securities on ESG. With this, almost all companies in our investment universe have an ESG rating. This allows us to integrate ESG in the quantitative assessment of the companies that we invest in and monitor progress closely."

This significant shift is part of a journey that investors have been on for some time now. The EY historical data graphically illustrates how investors are moving to a more robust approach to the evaluation of disclosures. As figure 3 shows, for example, only 27% of investors surveyed were conducting a structured and methodical evaluation in 2016, but use of this rigorous approach has accelerated over the past four years.

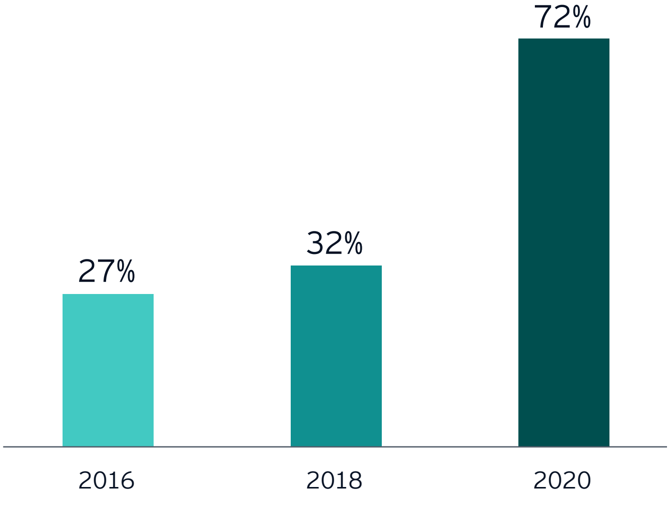
Of course, while the research shows a directional shift in philosophy toward a structured approach, it is the quality of the structured approach that is critical. "It's encouraging to see more organizations taking the first step, which is to go from informal to more formal processes," says Mathew Nelson, EY Global CCaSS Leader. "However, there's a lot more to do to truly embed a high-quality structured approach. You should start by formalizing and setting out the process you go through to do assessments. The next step will be the quality of the information that is captured through these consistent, approved processes, as well as the ability to make nuanced decisions on investments and the scale of those investments. While we're encouraged by the mindset shift, in reality, there is still more to be done in terms of formalizing a detailed approach and securing high-quality data."

72% of investors surveyed say they conduct a structured, methodical evaluation of nonfinancial disclosures.

Figure 3: Increasing numbers of investors embracing structured review of nonfinancial disclosures

Which of the following statements best describes how you and your investment team evaluate nonfinancial disclosures that relate to the environmental and social aspects of a company's performance?

Percentage of respondents who say they usually conduct a structured, methodical evaluation of nonfinancial disclosures



Asset owners practising what they preach: ESG at super fund HESTA

The investment community is not only looking to corporates to focus on ESG issues but also are practicing what they preach. HESTA's Mary Delahunty is not only focused on impact investing but also leads the fund's own sustainability charge. "We can't be critical of others unless we've got our own house in order," she says. "And that's why I'm leading on our own sustainability. We're a carbon-neutral fund ourselves and take a responsible investment approach across the portfolio. This is really important in terms of integrity, especially in the area of climate. Having an authentic approach is crucial to your social license."

Investors are embracing TCFD disclosures as part of evaluations

With investors focused on companies' exposure to climate change, ethical practices and the impact of operating models on communities, what information sources are they using for their evaluations? The research shows that investors are building their understanding of the ESG reporting universe. In particular, they are factoring in disclosures made as part of the TCFD framework (see figures below).

The extensive use of TCFD recommended disclosures reflects the challenges that investors can face in obtaining information about a company's existing climate-related risks and opportunities from other sources, as well as the climate-related impact on a company. The TCFD recommendations provide companies with a comprehensive framework to report the impact of climate risks and opportunities, systematically making it easier for investors to analyze a company's potential financial impact due to climate change.

67% More than two-thirds of investors surveyed say they make "significant use" of ESG disclosures that are shaped by the TCFD.

78% More than three-quarters of those who make significant use of that TCFD information say that it has a significant impact on investment decision-making.

> "It's encouraging to see more organizations taking the first step, which is to go from informal to more formal processes.
>
> **Mathew Nelson**
> EY Global CCaSS Leader

The issuer perspective

Is investor appetite for SDG information being met by companies?

This research also examined whether investors are using disclosures related to Sustainable Development Goals (SDGs) in their decision-making. We found that 59% said they were making significant use of that information. Of course, while investors are embracing SDG disclosures, there is still a lot that needs to be done to use the data provided by corporates to drive sophisticated, nuanced investment decision-making.

To understand if organizations are at least meeting that growing interest, this year's research included a data-driven analysis of the Global Reporting Initiative (GRI) Sustainability Disclosure, looking at whether the reports posted by companies include SDGs. The SDGs, set in 2015 by the General Assembly of the United Nations (UN) and intended to be achieved by the year 2030, are part of UN Resolution 70/1, the 2030 Agenda. They cover broad challenges such as economic inclusion, diminishing natural resources, geopolitical instability, environmental degradation and the impacts of climate change.

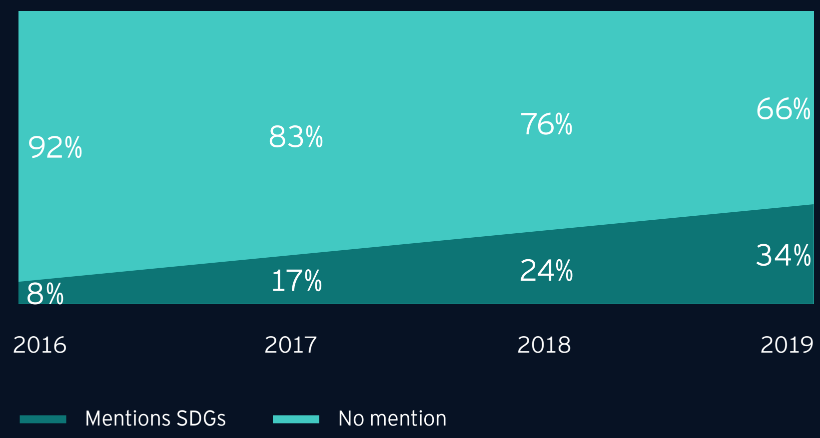
The analysis found that the use of SDGs by corporates is accelerating. In 2016, just 8% of reports mentioned SDGs; however, by 2019, this had reached more than one third (34%) of all reports posted by the target companies surveyed (see figure 4).

Of course, SDG-related disclosures will only be of value to investors if they are material and of high quality. For example, does SDG reporting have clear performance goals, showing how SDG commitments will drive long-term value, and is there an approach in place to assess and measure progress against goals? Effective measurement will be essential if leadership teams are to drive meaningful action and give investors credible information and data.

A senior ESG executive at a North American asset manager told us that there is still a need for SDG information to be more closely tailored to the needs of the investor community. "Originally, the SDGs were government goals and plans that have now been picked up by the private sector," they explain. "However, while the information may be very interesting to other stakeholders, it does not necessarily give us the data and information that we can use in our assessment of a company. For them to be broadly picked up by the investment community, there has to be a sort of translation, where what's presented is much more of an investor-oriented set of information."

Figure 4: Use of SDGs by corporates is accelerating

Percentage of issuer reports that feature SDGs vs. those that do not (GRI Sustainability Disclosure Database)*



*Note: sample of 6,743 global organizations.

About the research

This research program included a data-driven approach to analyze the GRI Sustainability Disclosure Database, conducted in February 2020. This analysis examined the database between 1999 and 2020, during which time 11,296 organizations had contributed nonfinancial reports to the site. The research focused exclusively on larger, listed companies, including multi-national enterprises. This left a research sample of 6,743 organizations that, between them, had published 35,294 reports to the website between 1999 and 2020.

Investors have a strong appetite for a formal approach to assessing intangible value

Too often, companies' disclosures fail to establish whether intangible assets are driving organizational performance. Without this insight, investors may be deprived of important information about how businesses create, measure and communicate long-term value. Take culture as an example: it is a critical intangible asset that plays a central role in reducing risk and delivering long-term, sustainable growth.

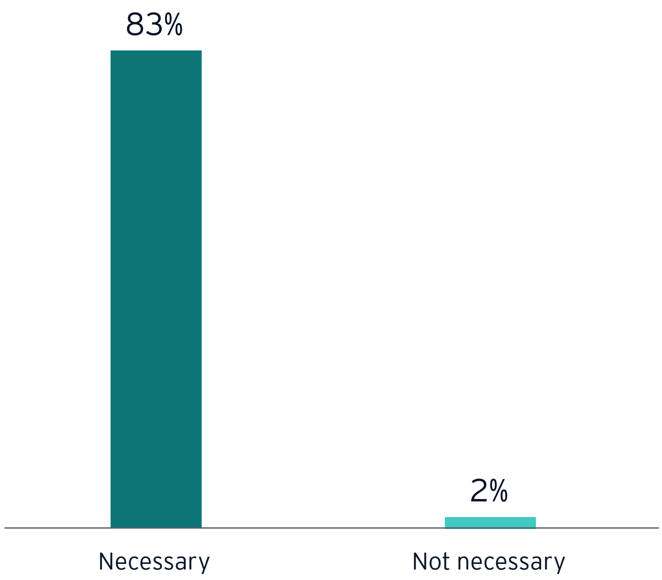
Access to greater insights into intangible assets — such as intellectual property, talent, brand and innovation — allows investors to look beyond book value.[6] In the past, 80% of the market value of a company could be read off the balance sheet; now, on average, just 48% is on the balance sheet. In Silicon Valley, the difference is especially stark: companies there only have, on average, 10% of their value on the balance sheet.[7]

The research shows that there is significant investor appetite for a formal framework that allows corporates to measure and communicate intangible value so that investors can evaluate their long-term value creation strategy (see figure 5). Eighty-three percent say it is necessary, including 40% who say it is "very necessary."

One initiative that can help companies to explain how their investments in talent, innovation, social goals and corporate governance create long-term value is the Embankment Project for Inclusive Capitalism (see "A framework for reporting intangibles and long-term value: the Embankment Project for Inclusive Capitalism").

Figure 5: There is significant appetite for a formal approach to measuring and communicating intangible value

Do you see a new formal approach to measuring and communicating an entity's intangible value as necessary in assessing long-term value?



Note: excludes "neutral" responses.

Only 2% of investors don't see the need for a formal framework to measure and communicate intangible value.

[6] "Isn't It Time the Intangible Became Tangible When Measuring Long-Term Value? EY — Global." Building a Better Working World — https://www.ey.com/en_gl/trust/isn_t-it-time-the-intangible-became-tangible-when-measuring-long. Persico, Felice. 28 Mar. 2018
[7] "Measuring Long-Term Value: Nothing Is More Practical than a Good Theory.", EY, 2019."

A framework for reporting intangibles and long-term value: the Embankment Project for Inclusive Capitalism

The Embankment Project for Inclusive Capitalism (EPIC) brought together the Coalition for Inclusive Capitalism, EY and 31 companies, asset managers and asset owners with approximately US$30 trillion of assets under management, in pursuit of a single goal: to identify and create new ways to measure and demonstrate long-term value to financial markets.

EPIC developed 63 indicators and a framework that helps organizations to measure and communicate long-term value creation for a broad set of stakeholders, not just shareholders. The approach provides a set of indicators that organizations can use in four categories: financial value, consumer value, human value and social value.

The next phase in the project is to leverage the EPIC findings and framework to identify, manage and measure the intangible assets that are often the greatest contributors to an organization's success. EY teams are committed to supporting a comparable and scalable framework that will support organizations in building out the connection between the tangible and intangible assets contributing to long-term value creation.

Long-term value approaches also informed the EY contribution to the initiative by the World Economic Forum (WEF) to develop a common, core set of metrics and recommended disclosures that corporates can use to report the shared and sustainable value they create. The WEF's 2020 consultation paper, *Toward Common Metrics and Consistent Reporting of Sustainable Value Creation*, outlined consistent metrics under four ESG pillars: Principles of governance, Planet, People and Prosperity.[8]

For more information on EPIC, visit **epic-value.com** and **www.ey.com/ltv**

[8] "*Toward Common Metrics and Consistent Reporting of Sustainable Value Creation*." World Economic Forum, 2020, http://www3.weforum.org/docs/WEF_IBC_ESG_Metrics_Discussion_Paper.pdf

> We need to acknowledge that we cannot look to replicate an approach to reporting and disclosure from the traditional financial perspective onto a sustainability perspective.
>
> **Jacob Michaelsen**
> Nordea

Of course, companies that want to give investors a comprehensive view of how they plan to create, measure and communicate long-term value for all stakeholders, should ensure a connection between financial and nonfinancial reporting. Financial performance comes from success in areas such as access to, and use of, resources: for example, manufacturers' use of water resources. As a result, long-term performance and value creation should be assessed holistically and through the lens of longer-term business sustainability. However, investors surveyed say that this connection is missing: their number one challenge to the usefulness and effectiveness of ESG reporting is the disconnect between ESG and mainstream financial information (see figure 6).

Figure 6: The top five challenges to the usefulness and effectiveness of ESG reporting

Thinking generally about the ESG reporting you receive, which of the aspects below, if any, do you believe are challenges to its usefulness and effectiveness?

1	The disconnect between ESG reporting and mainstream financial information	46%
2	The lack of real-time information	41%
3	The lack of information about how the company creates long-term value	41%
4	The lack of focus on the material issues that really matter	37%
5	The lack of forward-looking disclosures	37%

Note: percentages of the same numeric value are ranked by decimal point difference.

The effective connection of nonfinancial and financial disclosures hinges on the intangible value already recognized by investors. How can organizations identify, manage and measure the strategic assets that bridge the gap between the financial and nonfinancial contribution to society and the economy? EY teams have developed a framework that can address this question, which is based on three high-level phases that guide organizations in understanding their long-term value:

1. Identify intangible assets and the contributing value levers
2. Validate desired outcomes for each value lever and build a long term value impact matrix
3. Formulate a measurement and valuation process with metrics and a long-term value reporting process

For Nordea's Jacob Michaelsen, a stronger connection between financial and nonfinancial reporting does not automatically mean expecting ESG reporting to replicate financial reporting outputs, but instead focusing on consistency across ESG reporting standards and how investors use the information provided. "We need to acknowledge that we cannot look to replicate an approach to reporting and disclosure from the traditional financial perspective onto a sustainability perspective," he says. "That is to say, we shouldn't necessarily steer our efforts toward an output that looks similar to a traditional financial analysis. But, it's also important to be mindful about what people are saying about the need for some form of standardization. We do need to have some form of comparability in measurements. I think we in the market need to be better at understanding how we can go about setting up broad lines for standardization, as soon as possible. This would not just be around the reporting itself, but also the usage of those disclosures. Regulation can certainly play a role here, but it should be balanced with also letting the markets try to work out what works and what does not."

2 The ESG performance disconnect: environmental risk in the spotlight

A growing disconnect threat

As we have seen, investors are on a journey to formalize their approach to ESG evaluation. They are looking for corporates to provide standardized and rigorous nonfinancial data to support their approach, and any expectation gap between corporates and investors could come at a significant price. For example, companies that do not align with investor expectations could find it harder to access capital. They could also see a decline in their stock value, with investors that are concerned about lack of risk insight responding by raising a company's risk profile. Choosing not to engage on ESG, or weighting performance solely toward positive aspects may lead to investors coming to their own conclusions.

Obtaining ESG performance information that helps investors to compare corporates can be challenging. There is no consistent view on what ESG information is material, and there are a number of different standards on what or how to report this information. Investors are consistently stating that a common set of standards is crucial to improving the quality of nonfinancial disclosures and that it will facilitate better decision-making on investments. The WEF International Business Council (IBC) launched a project to consider how this challenge could be overcome and whether there could be a set of nonfinancial metrics that all companies report on to enable some element of performance comparison. The WEF IBC report *Toward Common Metrics and Consistent Reporting of Sustainable Value Creation*[9], proposes a first draft of what a common core set of metrics and disclosures could be.

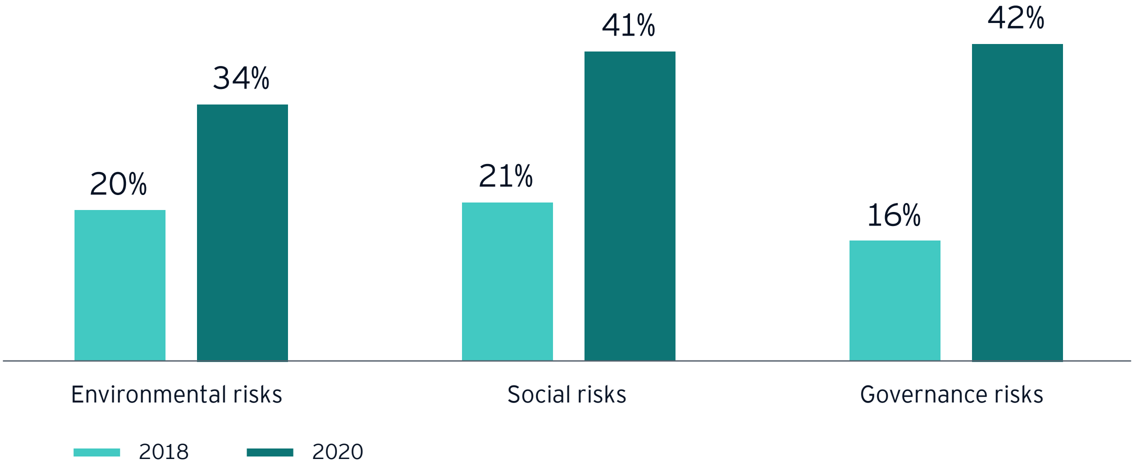
For NN Investment Partners' Adrie Heinsbroek, a good way to close any disconnect is for corporates to see their interactions with the investment community as a relationship. "Sometimes, companies are a bit reluctant to share particular types of information with us," he says. "While it's sometimes understandable, you need to make sure that they understand that you're not going to use it against them. The aim is to try to understand them better. I always say to these companies, 'your risk is our risk.' In order to have a good shareholder relationship, it is important to have dialogue about exactly these topics. Because if we don't have the information, we have to make a judgment on our own intuition."

One of the biggest areas of disconnect is in how companies are disclosing ESG risks to their current business models. For example, as figure 7 shows, dissatisfaction with risk disclosures has risen since 2018, across the board — environmental, social and governance and the number of investors that are dissatisfied with environmental risk disclosures has increased 14 percentage points since 2018. Moreover, 86% of those investors that are dissatisfied with the environmental risk information they receive say it is "critical" that disclosures in this area improve.

Figure 7: More investors dissatisfied with ESG risk disclosures

In your opinion, do companies adequately disclose the ESG risks that could affect their current business models?

Percentage of respondents who say that companies do not adequately disclose the ESG risks that could affect their business models



[9] *"Toward Common Metrics and Consistent Reporting of Sustainable Value Creation."* World Economic Forum, 2020, http://www3.weforum.org/docs/WEF_IBC_ESG_Metrics_Discussion_Paper.pdf

Investors are focused on TCFD climate risk disclosures, but questioning insight into processes for managing risk

It is clear from the research that environmental risk is a key issue for investors. Earlier in this report, in "Investors are embracing TCFD disclosures as part of evaluations", we saw that more than two-thirds of investors make significant use of ESG disclosures that used the TCFD framework. And, when investors were asked about the most valuable way that companies can report ESG information, the TCFD framework also emerged on top. The top three most valuable ESG disclosure vehicles are:

1 Climate-related disclosures in financial reports as recommended by the TCFD

2 Company disclosures based on what management believes is most material to the company's value-creation strategy

3 Company-defined reports that integrate financial and nonfinancial information

For Dr. Matthew Bell, EY Asia Pacific CCaSS Leader, the popularity of the TCFD framework also points to its value beyond climate-risk reporting. "It's fascinating to me that the top three results from the survey all allude to a desire for more value-connected means of reporting. Investors' regard for the TCFD framework might not just reflect their view that it's best-in-class in the context of climate reporting, but that its approach could be seen as a framework for other ESG-related topics," he says. "For example, the TCFD framework can lend itself to COVID-19 disclosures. This is because it sets out 'the now, next, and beyond', and details this across strategy, risk management, metrics and targets, and governance. The disconnect between financial and nonfinancial information is something the TCFD is also designed to address. At a minimum, there's an opportunity for the market to ask what we can learn from the TCFD framework, why it has earned such acceptance, and what its relevance to other ESG factors might be."

The TCFD recommendations are particularly aimed at sectors that are identified as especially vulnerable to climate change impacts. These include both the financial sectors (e.g., banks, insurance companies, asset owners and asset managers) and nonfinancial sectors (e.g., energy, transportation, materials and buildings, agriculture and food, and forest products). While implementation of the TCFD recommendations is largely voluntary, investor appetite for this information will likely drive further uptake of the recommendations in nonfinancial reporting.

However, despite the importance of this information to how investors evaluate companies, the *2019 EY Global Climate Risk Disclosure Barometer* – which assesses company reporting – found that responsiveness to the TCFD recommendations differs significantly between countries and sectors.[10] There were question marks around the depth of the disclosures on climate risk exposure and resilience, and the *2019 EY Global Climate Risk Disclosure Barometer* found room for improvement in both the coverage and quality of disclosures by companies. There is a pressing need to ensure that the quality of TCFD disclosures reflects how extensively they are used by investors in evaluation.

This latest EY research also points to concerns regarding the information provided. The TCFD recommendations are structured around four thematic areas of risk: governance, strategy, risk management, and metrics and targets. Investors' greatest concern about the TCFD framework is the risk management element, which provides insight into how companies actually identify, assess and manage their key climate risks. Investors were asked to name the area where they received the least-developed information from companies, and risk management came out on top (see figure 8). This may reflect the fact that while some companies disclose that they have processes for identifying and managing climate risks in their overall organizational risk management system, this is described in general terms without a clear link between the climate-related and overall risk management.

Figure 8: Risk management is the least-developed TCFD area

Thinking about the four areas of the Task Force on Climate-related Disclosures, which is least developed in terms of the information provided by companies?

1	Risk management	30%	of respondents say this is the least-developed area
2	Governance	27%	
3	Metrics and targets	23%	
4	Strategy	20%	

HESTA's Mary Delahunty believes that improvements in TCFD disclosures will evolve naturally as best-in-class companies emerge that others will want to emulate, creating a natural consistency. "I think with time, certain TCFD terms will become accepted," she explains. "That will then create its own level of consistency. Standout performance using that TCFD framework will start to set the standard for areas that companies can excel." She also feels that investors will increasingly expect companies to take a robust approach to the four areas. "Overall, we should be less accepting of light-touch disclosures in those four areas," she says. "They can be well understood if a company is focused to do so."

TCFD: four thematic areas of risk

- **Governance**: the organization's governance around climate-related risks and opportunities
- **Strategy**: the actual and potential impacts of climate-related risks, and opportunities on the organization's businesses, strategy and financial planning
- **Risk management**: the processes used by the organization to identify, assess and manage climate-related risks
- **Metrics and targets**: the metrics and targets used to assess and manage relevant climate-related risks and opportunities

10 "*How Can Climate Change Disclosures Protect Reputation and Value?*", ey.com, https://www.ey.com/en_gl/assurance/how-can-climate-change-disclosures-protect-reputation-and-value, accessed 27 April 2020.

Strategy — an area for concern

While strategy is the thematic area that received fewer negative votes, one in five investors (20%) identified it as their least-developed area. This is something that is echoed in the *2019 EY Global Climate Risk Disclosure Barometer*.[11] The assessment of company climate risk disclosures finds that many companies fail to align sustainability and risk management in a way that integrates climate change risk factors into the overarching strategy of the company and enterprise risk management system. This has resulted in very broad and high-level approaches to analyze how climate-related risks and opportunities have affected the business organization, strategy, and financial planning.

"The sustainability functions of companies have been very good at understanding what ESG performance matters could impact corporate value for their stakeholders over the long-term, but often find that these insights get 'watered-down' or lost altogether when embedded into wider risk and strategy processes," says EY's Dr. Matthew Bell. "From what investors are telling us, there's an opportunity for those functions to be more embedded into core business."

Furthermore, it was found that many companies do not consider their current strategy's resilience against climate-related risks and lack a structured approach to identifying climate-related opportunities. This is arguably an implication of the companies' under-utilization of climate scenario analysis, which otherwise could help companies

Driving effective climate change risk disclosures: actions

In the EY report, *How climate change disclosures reveal business risks and opportunities*, we examined how important it is that organizations have a strong grasp of the range and magnitude of the financial impacts from climate change.[12]

Disclosing climate-related risks likely requires changes to the governance and risk assessment processes (in line with the TCFD recommendations). It may take several years for an organization to be in a position to generate valuable information for investors and shareholders to help them make informed decisions. The earlier organizations embark on this journey — and provide a platform to help educate directors and management about climate risks — the better positioned they should be to engage with investors and shareholders on the impacts and opportunities.

Companies that seek to understand their climate risk exposure can ask themselves the following questions:

- What are the biggest emissions sources in our value chain?
- What incentives, instruments and indicators can help us to align our strategy with the goals of the Paris Agreement (the Paris Climate Change Conference, which was held in 2015, was the 21st meeting of the Conference of the Parties of United Nations Framework Convention on Climate Change)? For example, an internal carbon price on capex and opex and company-specific targets.
- What are our stakeholders' expectations of climate footprint and carbon performance? For example, to lead the development of sustainable products and services or disclose information required by investors.
- What type of climate risks is the business exposed to in the long run?
- How will our products and services be affected by carbon policies and targets? How can we anticipate the impacts and adapt?
- Are the international climate policies and national commitments integrated into our business strategy and our supply chain and sourcing strategy?
- What is our potential exposure to new regulations such as carbon taxation and carbon pricing? What assets are at risk — supply chain, products or activities — and in which geographies?
- Are some of our products or activities at risk from the 2°C roadmap (limiting global warming to two degrees Celsius to try to avoid the worst consequences of climate change)? How can we turn that into a competitive advantage?

11 "How Climate Change Disclosures Reveal Business Risks and Opportunities.", ey.com, https://www.ey.com/en_ae/assurance/climate-change-disclosures-revealing-risks-opportunities, 9 January 2019.

12 Ibid

structure their climate-related risk and opportunity identification process and assess their current strategic trajectory.

The analysis also found that companies, in many instances, do not cover some of the most material climate-related risks that they are exposed to. For example, many financial institutions in the *2019 EY Global Climate Risk Disclosure Barometer* research disclose greenhouse gas (GHG) emissions in relation to their own operations (e.g., Scope 1 and 2), but disclose very little information on their GHG emissions relating to investments and lending activities (e.g., Scope 3). This finding also means that the Scope of climate-related metrics is often confined to Scope 1 and 2 GHG emissions. For the companies that do report on Scope 3 GHG emissions, these disclosures usually include non-material emissions, such as business travel. Thus, to a large extent, companies need to focus on and disclose their most material Scope 3 emissions.

Many companies fail to consider their current strategy's resiliency against climate-related risks.

Leading the way in ESG performance: the sector view

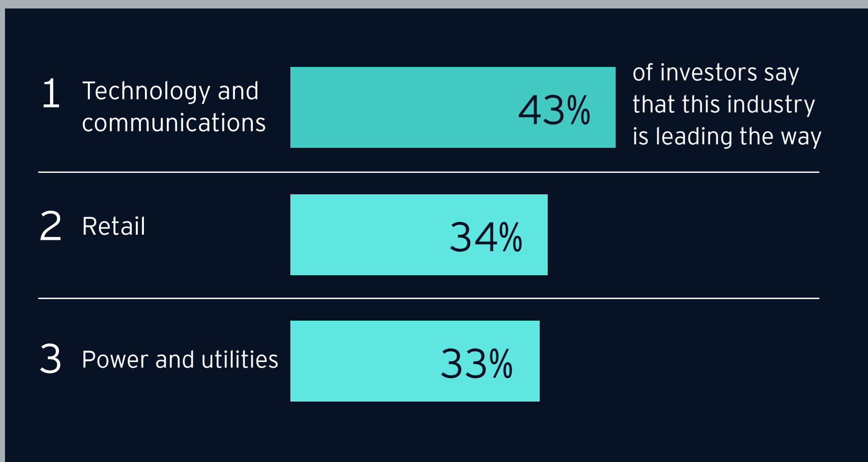
This survey asked investors to evaluate 10 sectors and say whether they felt they were leading the way in ESG reporting compared with other industries, meeting expectations or lagging behind. Given the importance of industry-relevant information to investors, the ranking of different sectors illustrates who is potentially meeting that need.

The technology and communications industry is seen as leading the way more than any other sector (see figure 9).

This resonates with the findings of the *2019 EY Global Climate Risk Disclosure Barometer*, in which the telecommunications sector scored highest for coverage and second-highest for quality of TCFD disclosures. This may be because the industry, more than any other, is embracing the opportunities associated with an economy-wide low-carbon transformation, and is paying attention to the potential impacts on its physical networks. After all, the incentives for disclosure are as much about the upside as the downside.

Figure 9: The top three sectors for ESG reporting

Considering the following industries, and thinking about the maturity of their ESG reporting compared with other sectors, please say whether you feel that they are leading the way in ESG reporting, meeting expectations, or lagging behind.



3 Investors are holding companies accountable

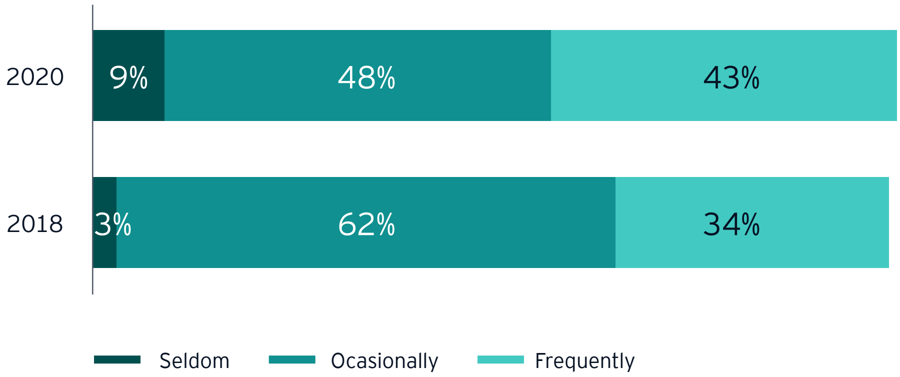
ESG is fundamental to investment decision-making

The importance of strong alignment between corporates and investors is reinforced by the central and decisive role that ESG information plays in investment decisions: 91% of investors surveyed say that nonfinancial performance has played a pivotal role in their investment decision-making over the past 12 months either "frequently" or "occasionally." Furthermore, the proportion of investors that say this happens frequently has jumped to 43% from 34% in 2018 (see figure 10).

This increase reflects a continuing trend that has been tracked in our historical research. In 2016, for example, 68% of investors surveyed said that nonfinancial performance had played a pivotal role in their investment decision-making either frequently or occasionally, compared with today's 91%. Additionally, as figure 11 shows, only 27% of investors were making "frequent" use of nonfinancial performance in the same year. This trend in using nonfinancial information to determine a businesses' value is likely to continue in a post-pandemic world, as investors look not only at a businesses' resiliency, but also at the alignment of their purpose to long-term value creation.

Figure 10: Nonfinancial performance is now used more frequently in decision-making

In the past 12 months, how frequently has a company's nonfinancial performance played a pivotal role in your investment decision-making?

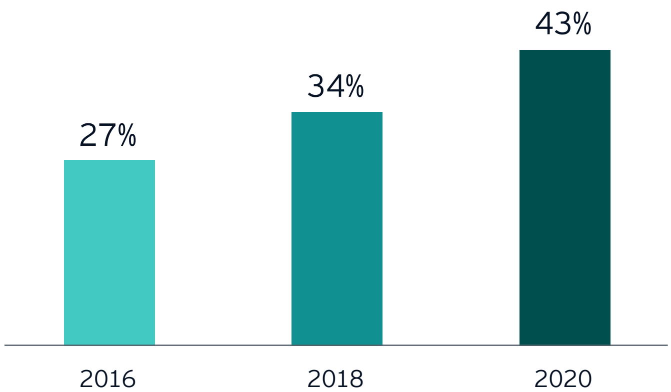


Note: excludes the investors that answered "never".

Figure 11: Frequent use of nonfinancial performance in decision-making is on the rise

In the past 12 months, how frequently has a company's nonfinancial performance played a pivotal role in your investment decision-making?

Percentage of respondents who say that they have made frequent use of nonfinancial performance in investment decision-making



> Only 27% of investors were making "frequent" use of nonfinancial performance in 2016.

A fundamental shift in investor ESG culture: the importance of conviction and belief

The evolution of culture within institutional investors is clear. Interviews for this research show a significant change in expectation for fund managers to take ESG seriously. Back in the first EY investor study, which was conducted in 2013, one US-based third-party investment portfolio manager characterized ESG evaluation as something of more interest to the younger generation, saying, "There are people who are coming into the business today who are probably more focused on it than I am."[13]

But today, discussions with industry leaders demonstrate significant diligence within firms to ensure a culture of ESG is being maintained. When assessing how the investment industry approaches ESG decision-making, ABN AMRO's Vincent Triesschijn believes that it is critical to also take into account the convictions and beliefs of investment managers and whether they truly "believe" in ESG. When assessing the external investment fund managers offered to its clients, the bank not only gathers wide-ranging information, but also assesses whether the fund manager's people believe in the ESG-driven approach. "Investment funds are subjected to an intensive analysis consisting of questionnaires with qualitative questions that we assess ourselves," he explains. "We also visit the fund managers' offices to conduct a thorough due diligence."

The survey also shows that investors are focused on climate change risk and are making extensive use of both positive and exclusionary screening. These two areas are covered in more detail later in the report.

The climate imperative: physical and transition risk are critical to asset allocation and selection

Investors are paying increasing attention to climate change as they seek to understand what it means for companies and the potential for a systemic financial shock to the economy. In the EY *Megatrends 2020 report*[14], new technologies reveal that climate-driven geophysical change is happening much faster than first thought. This is creating additional pressure for business leaders to adapt more quickly to climate risk because of the potential for disruption to supply chains and damage to infrastructure.

We saw earlier – in "Investors are focused on TCFD climate risk disclosures, but questioning insight into processes for managing risk" — that TCFD recommended information is seen as critical to investors in securing the information they need on a company's existing climate-related risks. The TCFD disclosures characterize risks and opportunities along two dimensions — physical impacts and transition impacts:

- **Physical risk**: risk to asset valuation and returns that may be posed by changes in the physical climate. For example, changes in rainfall patterns could impose climate-related constraints on operating activities.
- **Transition risk**: transitioning to a decarbonized economy may entail extensive policy, legal, technology and market changes to address mitigation and adaptation requirements related to climate change, which could pose varying levels of financial and reputational risk to organizations. For example, climate-related financial risks could affect the economy through elevated credit spreads, greater precautionary saving and rapid pricing readjustments.

[13] Climent, Juan Costa. Tomorrow's Investment Rules Global Survey of Institutional Investors on Non-Financial Performance. EYGM Limited, 2014, https://www.eycom.ch/en/Publications/20140502-Tomorrows-investment-rules-a-global-survey/download.
[14] "Are you reframing your future or is the future reframing you?" EYGM Limited, 2020.

The EY research finds that 73% of investors surveyed say that over the next two years they will devote considerable time and attention to evaluating the physical risk implications when they make asset allocation and selection decisions; 71% say the same of transition risk. Investors that take a structured, methodical approach to evaluating nonfinancial disclosures pay more attention to these issues than those who say they evaluate nonfinancial disclosures informally (see figure 12).

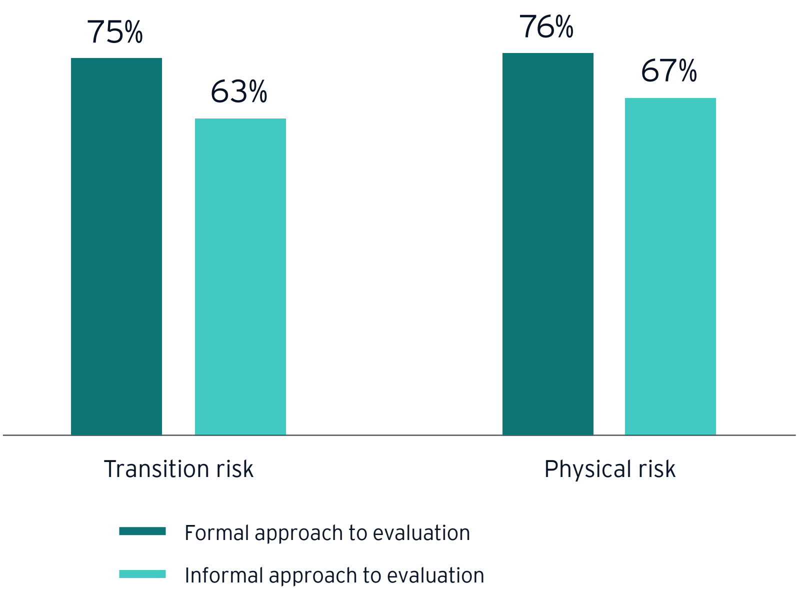
In EY teams' experience, corporates' assessment of the impact of physical climate risks falls behind that of transitionary impacts, particularly regulation. This is a problem, as the risks are two sides of the same coin. One reason why there is a more consistent consideration of transition risk is the more immediate likelihood of consequences. Transition risks are generally associated with "mitigation" — actions taken to reduce the likelihood and consequence of future physical consequences. So, although companies in some sectors have considered the physical implications of a changing climate, most have not yet fully integrated them into their valuation models.

The *2019 EY Global Climate Risk Disclosure Barometer* finds that physical risks are not only overlooked in valuation models but often omitted altogether from forward-looking strategic and risk management disclosures. Physical risk is key to many high-risk sectors over the long term, so this lack of understanding and disclosure highlights a significant shortfall in the quality of disclosures.

Figure 12: Physical and transition risks are critical considerations in asset allocation and selection

Thinking about climate change specifically, how much time and attention will you devote to evaluating transition risk and physical risk in your asset allocation and selection decisions over the next two years?

Percentage of respondents who give significant time and attention to transition and physical risk



Investors are devoting considerable time and attention to evaluating the implications of physical and transition risks when making investment decisions.

Meeting investor expectations on transition and physical risk: where to start?

Disclosing climate-related risks that meet the needs of investors is likely to demand changes to companies' governance and risk assessment processes. It may take several years for organizations to be able to generate the information that will help investors to make informed decisions. The earlier they start to educate directors and management about climate risks, the sooner they will be able to engage with investors on the possible impacts – as well as the opportunities for the organization.

Exclusionary and positive screening are used extensively

In September 2019, institutional investors responsible for more than US$4.6 trillion in investments formed the UN-convened Net-Zero asset Owner Alliance. The aim was to use their financial influence to combat climate change, with the group committing to move their portfolios to net zero GHG emissions by 2050.[15]

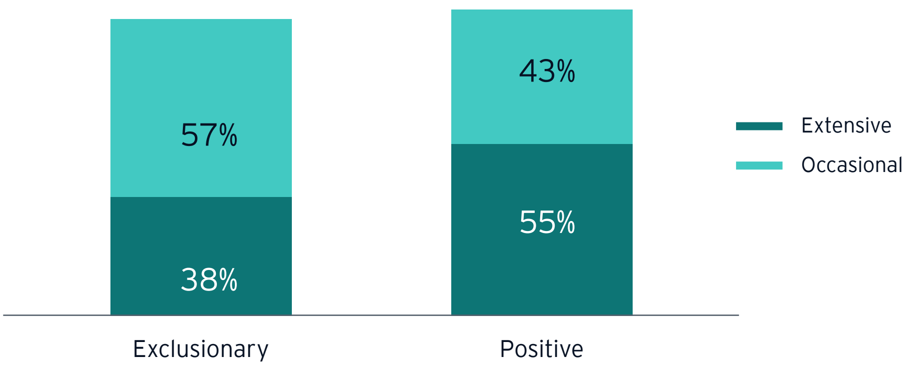
The research shows that this kind of sustainable investing is on the increase. It involves exclusionary screening, such as excluding emissions-intensive activities from a fund or portfolio, and positive screening, which means investing in sectors, companies and projects that are chosen for their positive ESG performance relative to industry peers. These approaches co-exist with traditional techniques such as value investing, and most investors are using both exclusionary and positive screening to inform their decisions (see figure 13).

In September 2019, institutional investors responsible for more than US$4.6 trillion in investments formed the Net-Zero Asset Owner Alliance.

Figure 13: A significant number of investors are making extensive use of exclusionary and positive screening

To what extent does your institution use the following approaches to integrate ESG issues into its investment decisions?

Percentage of respondents who make extensive or occasional use of screening



[15] "UN-Convened Net-Zero Asset Owner Alliance – United Nations Environment – Finance Initiative." United Nations Environment – Finance Initiative – Partnership between United Nations Environment and the Global Financial Sector to Promote Sustainable Finance, https://www.unepfi.org/net-zero-alliance/. Accessed 29 May 2020.

The extensive use of positive screening reflects its growing importance in sustainable investing. Investors are using positive screening of ESG risk factors to create a modern best-in-class investment approach that generates performance that is in line with — and often exceeds — market benchmarks.

For Nordea's Jacob Michaelsen, positive screening is a critical part of impact investing and building a more sustainable future. "Increasingly, investors are moving away from a binary analysis of invest or divest," he says. "Exclusion can still be relevant as a tool for sustainable investments. However, it is not the only tool and it is not always the most effective tool. If you are selling off your 'dirty' investments to investors that do not care about this, there's a bit of a hazard that basically you're saying, 'Well, it's somebody else's problem.' So actually, to an extent, we would be better off if the most sustainable investors bought the least sustainable investments, because those investors will be able to put more pressure on the company to change."

> "Increasingly, investors are moving away from a binary analysis of invest or divest.
>
> **Jacob Michaelsen**
> Nordea

4 The future of ESG performance: trusted and credible

ESG is critical to success in the post-COVID new reality

The COVID-19 global health pandemic — rather than distracting us from the need to drive a sustainable future — reinforces that imperative. The transition to a decarbonized future is critical to the long-term resilience of companies, the economy and the planet as a whole. Strong ESG strategies and frameworks will likely be critical to recovery and thriving in the long-term future.

Investors will be keeping a close eye on how countries and organizations recover from the economic impacts of the pandemic. The national economies and companies that set an agenda for climate-resilient growth will likely be seen as an attractive prospect, both in terms of near-term opportunities, such as job creation, and their long-term ability to withstand systemic shocks.

For investors to understand a company's resilience maturity, they need to have insight into the ESG risks that companies face and how they intend to manage them. Credible and trusted ESG disclosures are therefore essential. The research has found that there is significant appetite among investors to build trust in the credibility of ESG disclosures. This appetite perhaps reflects some of the factors that can weigh on investors' confidence in ESG disclosures:

- Because nonfinancial disclosures can involve qualitative information, investors worry that it is a subjective viewpoint rather than evidence-based fact.
- Investors may worry that there is no transparency into the assumptions that underpin the data, and ask whether those assumptions are reasonable.
- ESG disclosures are often supported by immature processes and can involve judgment calls that may increase risk.

For ABN AMRO's Vincent Triesschijn, transparency is also about the willingness of companies to be open to questions and discussion. "An important element in evaluating [ESG] data is the extent to which companies are responsive to questions and engagement," he explains. "However, geographical and cultural differences can create a barrier to finding reliable information. Generally, we prefer to invest in companies that we understand well and that are open to discussions. The same principles apply to external investment managers. In the end, transparent and reliable sustainability-related information will contribute to better, more informed, investment decisions that benefit the risk-return characteristics of both companies and investment portfolios."

NN Investment Partners' Adrie Heinsbroek points out that transparency is also about organizations that are willing and motivated to be open. "I need to understand what a company's objectives are," he says. "Sometimes, reading between the lines is just as important as having the words put on paper. I want companies to tell and share with us what they want to share with us. Let them tell their story and allow us to ask them questions."

As part of that open approach, Adrie Heinsbroek believes that organizations also need to be transparent about challenges and dilemmas, which both companies and investors can then learn from. "More disclosure is not always better," he says. "In the early days of sustainability reporting, the big leap forward was that companies also started to share and disclose some of the dilemmas they faced. Today, a lot of it only looks like good news. You also need to disclose some dilemmas or some failures. Then, the companies — and we as investors — can say 'Let's learn from that.'"

According to a senior ESG executive at a North American asset manager, consistency is a major element of credibility, with the Sustainability Accounting Standards Board (SASB) helping to drive the consistency and materiality of disclosures. "The consistency piece is very important," they say. "We are very supportive of the SASB standards, which help provide that consistency in terms of 'these are the material metrics and here's how you report out on them.' You would then have to explain year over year if, for some reason, you chose not to report on that metric. I think a lot of ESG reporting is still very qualitative and narrative-driven and, while you sometimes need that for context, it has to be backed up with a solid data set that does not change from year to year."

Next we examine investors' appetite for assurance across the ESG spectrum – from climate-related disclosures in financial reports to green investment disclosures.

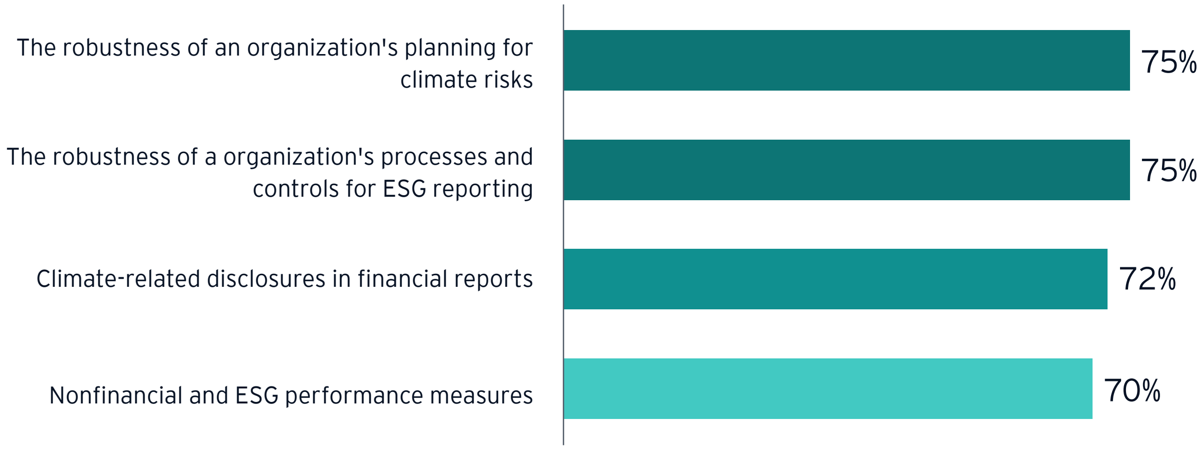
Building trust and credibility in climate-related disclosures

As we saw earlier in this report, in "the ESG performance disconnect: environmental risk in the spotlight" environmental issues are front of mind for investors. However, environmental and climate change disclosures — and insight into companies' approaches to managing the related risks — are only useful to investors if they have confidence in what is reported. The research uncovers significant appetite for expanding the scope of assurance to provide that credibility and confidence: for example, as figure 14 shows, 75% would find value in assurance of the robustness of an organization's planning for climate risks.

Figure 14: Investors say there is significant value in independent, third-party assurance across the ESG spectrum

From your perspective, how valuable is it to have a third-party firm provide independent assurance over the following information?

Percentage of respondents who see independent assurance as "valuable" or "very valuable"



This suggests that the investor community, given its reliance on nonfinancial information, will play an active part in pushing corporates toward nonfinancial assurance.

Corporates that want to access capital and communicate their story to investors will need to respond to this investor-led demand.

The issuer perspective

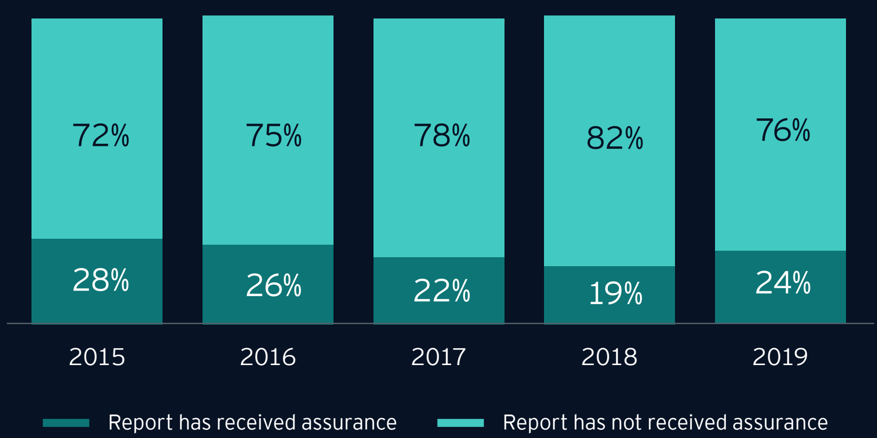
Are companies responding to investor focus on trust and credibility?

Investors are clearly focused on whether ESG information is credible and trusted. To understand if corporates are meeting this need, the data science-based analysis of the GRI's Sustainability Disclosure Database examined whether the reports posted by companies have received a form of external assurance.

The research shows that around a quarter (24%) of organizations in the sample say that the report they posted in 2019 has undergone a form of external assurance. As figure 15 shows, a significant part of nonfinancial information does not receive that validation.

Figure 15: Despite investor demand, most reports do not receive external assurance

Percentage of issuer reports that have received a form of assurance vs. those that have not



*Note: sample of 6,743 global organizations. See page 11 for sample information.

Building confidence in green investment disclosures

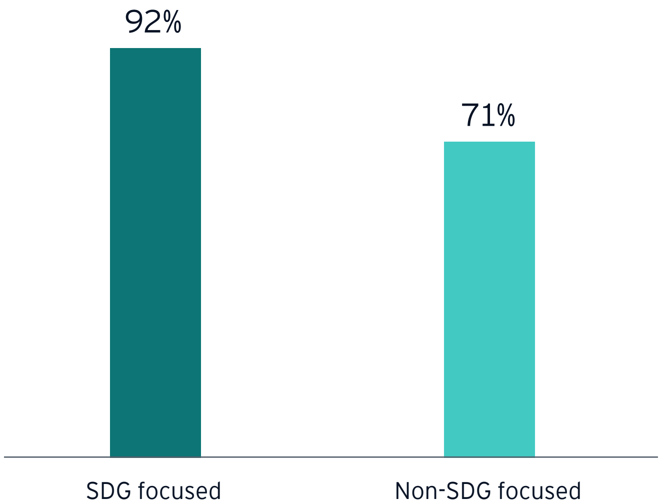
In today's market, there is demand for consistent and in-depth information on how corporates are deriving revenue and growth from environmental solutions. But a significant number of investors are concerned that the information they receive is limited. For example, close to half of the Europe-based investors in the study (46%) do not feel that they are given very robust and credible information on green bonds and the green performance and impact of investments.

It is perhaps not surprising, therefore, to find that there is significant appetite for assurance of this information: 82% of investors surveyed say it would be useful to have independent assurance of the impact of green investments and, of those, 34% say it would be "very useful." And the respondents who make extensive use of disclosures shaped by the UN SDG policies are particularly interested in that kind of assurance: 92% of this group think it would be valuable, compared with 71% of the respondents who are not so focused on the UN SDGs (see figure 16).

Figure 16: Investors would value assurance of green investment disclosures, and there is particular interest from SDG-focused investors

Thinking about the reporting information that companies disclose on the impact of green bond investments, how useful would it be to have independent, third-party assurance of that reporting?

Percentage of respondents who believe assurance would be "useful" or "very useful"



82% of investors surveyed say it would be useful to have independent assurance of the impact of green investments.

What are green bonds?

Green bonds can be used to fund or refinance past or future investments in a broad range of categories, including:

- Energy efficiency upgrades
- Renewable energy infrastructure
- Waste and pollution reduction
- Sustainable land, biodiversity and water management projects and infrastructure
- Green buildings
- Low-carbon transport
- Climate adaptation infrastructure
- Information and communication technology projects that reduce travel

What next?

Action in three areas is suggested for companies to meet the expectations of investors and ensure their ESG performance plays a critical role in the long-term response to the global pandemic:

1. Connect nonfinancial and financial information

The research shows that investors are concerned about the gulf that often exists between financial and nonfinancial performance. Resolving this is complicated by a lack of regulation related to the alignment of financial and nonfinancial information. To help close this gap, investors can focus on building more credible and nuanced approaches to understanding what influences long-term value for given sectors and companies, while corporates can focus more on their materiality – reporting on what environmental, social and economic factors are most relevant to their stakeholders that could impact their ability to create value over the longer-term. Closer collaboration and understanding between the finance teams involved in financial reporting and the teams involved in ESG performance and strategy will also be critical.

For this connection to be of value, companies should also assess whether their nonfinancial information is seen to be as credible as their financial disclosures. This requires nonfinancial reporting to be based on specific, investor grade metrics that are valued by investors and enjoy investor confidence. EY teams are currently working on an approach that is designed to allow corporates to identify, manage and measure the intangible assets, that are often the greatest contributors to an organization's success – building out the connection between tangible and intangible assets, and how they contribute to long-term value creation and a purpose-driven strategy.

2. Build a more robust approach to TCFD risk disclosures as the world transitions to a decarbonized future

The research findings show that there is a need for increased focus and understanding among companies – particularly those in high-risk sectors – of how they might be affected by climate-related risks in the short, medium, and long term, and how they manage those risks in the future. Robust TCFD reporting will be increasingly important as governments, regulators, and society as a whole look to companies to accelerate the transition to a net-zero GHG emissions economy. The clamor for disclosures on how businesses are planning to respond to physical climate risks – as well as the risks arising from the decarbonization transition – will likely intensify.

Critical actions include understanding the impact of climate change – including 1.5°C, 2°C and 4°C scenarios – and assessing the resilience of their business strategies in these different scenarios; capturing the opportunities associated with decarbonizing the economy; assessing avenues for accessing and attracting capital; and driving strategy with appropriate tools, such as shadow carbon pricing across their value chains.

Building a disciplined and connected approach to nonfinancial reporting will likely be key to meeting the expectations of investors.

3. Instill discipline into nonfinancial reporting processes and controls to build confidence and trust

ESG performance reporting generally lacks the rigorous systems and controls that characterize financial reporting. This is compounded by the fact that ESG reporting measures do not conform to standardized metrics. As a result, investors and corporates cannot guarantee the accuracy and reliability of nonfinancial reporting. Establishing effective governance practices and assurance of nonfinancial processes, controls and data outputs can build trust and transparency. This is an area where CFOs and their finance teams — with extensive experience in establishing processes, controls, and assurance of financial information — can bring their best practices and experience to bear. The input of CROs and their risk teams can also be valuable, as can treasury function input where green finance is involved.

Robust TCFD reporting will become increasingly important as the transition to a net-zero GHG emissions economy accelerates.

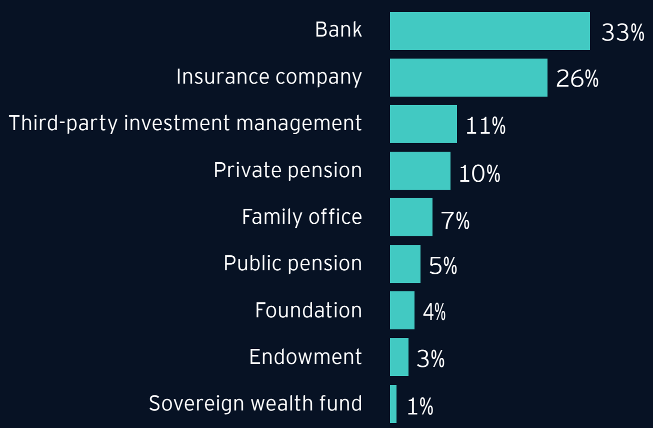
About this research

In February 2020, the EY Global Climate Change and Sustainability Services (CCaSS) Team commissioned Longitude to conduct its fifth survey of institutional investors to examine their views on the use of nonfinancial information in investment decision-making.

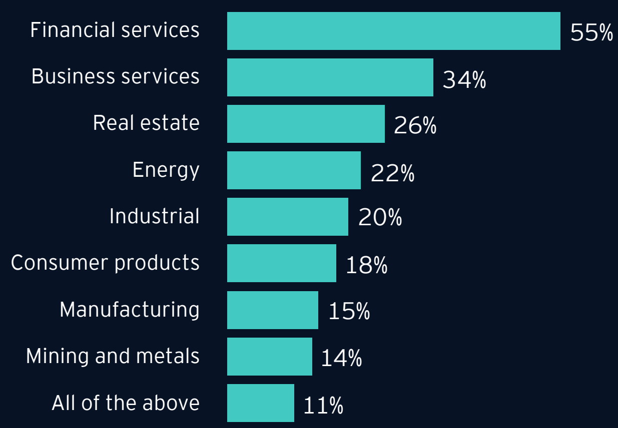
Longitude and the EY CCaSS Team collaborated on writing the questionnaire, incorporating some repeated questions from prior years along with a number of thematic questions on topics of near-term interest. In total, Longitude collected 298 responses from senior decision-makers at buy-side institutions around the world. Demographic highlights of the research program are below:

What is your title?

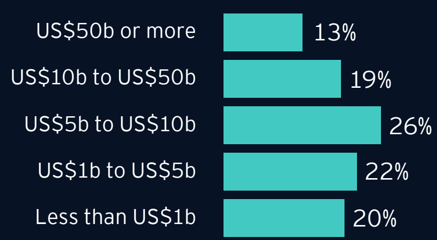
What type of institution do you work for?



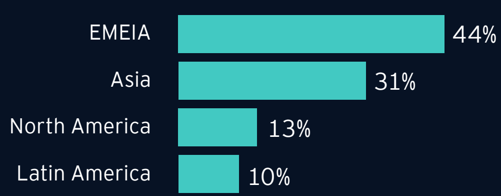
In which of the following sectors do you invest most heavily?



What are your institution's assets under management?



Where is your position located?



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