Risk, Returns and Resilience: Integrating ESG in the Financial Sector

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Message from Rajiv Memani

The COVID-19 pandemic has brought unprecedented challenges for the financial sector. In a short span of time, the sector has had to deal with priorities and issues for the now, next and beyond horizons of the pandemic. In many ways, the crisis is a reminder for us to strengthen the resilience of our financial systems, which are at the heart of a robust economy and a just society.

Sustainability has been the top agenda for global investors for the past few years, however COVID-19 has significantly accelerated the focus on climate change and adoption of sustainable practices as they make their investment decisions. For decision-makers, the need for risk management and resilience has brought attention to the larger environmental, social and governance (ESG) agenda. There has never been a better time for the financial sector to focus on ESG to build a resilient economy and create impact that benefits everyone, thus creating long-term value for all stakeholders.
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Risk, returns and resilience: Integrating ESG in the financial sector
As the world grapples with the COVID-19 pandemic, nations face a daunting task to re-build their economies in addition to handling a global health crisis. Businesses have been hit hard and the effects have been felt by the stakeholders. The road ahead is indeed fraught with challenges and calls for a change from business as usual to risk-resilient businesses of tomorrow.

Both the 2008 economic crisis and the pandemic painfully represent our vulnerability to global shocks. Managing all stakeholders has been the biggest challenge for businesses in this ongoing time of uncertainty which is proof that economic health cannot be built in isolation. Society and environment are equally important for businesses to flourish and going ahead all the ESG risks will have to be managed to build resilience into the system. As we re-examine the future of work and travel, we can choose to build an improved economic system that works for both people and the planet. No-sector is better placed to drive this transition to a sustainable economy and a stable future than the financial sector itself.

To design resilient economies of the future, we need systemic changes in the finance system which better accounts for all the risks—reputational as well as transition risks—which will lead us to the economy that we are headed to, i.e., net zero by 2050. Integrating ESG into the financial sector will pave a path for all stakeholders being considered in the decision-making process, which will result in real world impact benefiting everyone. This paper looks at the changing financial landscape from an ESG lens in the now, next and beyond horizons. It highlights the need for inclusion of ESG factors in their corporate strategy for managing risks and returns, while ensuring that we build resilient systems for long-term value creation.
Introduction

The COVID-19 crisis has shown us that our old systems are not fit anymore for the 21st century. In short, we need a Great Reset.

Professor Klaus Schwab  
Founder and Executive Chairman,  
World Economic Forum
Environmental risks have been constantly cited as the major risks threatening global economies for several years now. As per World Economic Forum’s Global Risk Report, the top five risks in terms of likelihood are all environmental risks and the top-most risk in terms of impact is that of climate action failure.¹

Over the years, there has been a lot of debate regarding the adoption of ESG principles as a way of doing business. The natural disasters and catastrophes due to climate change have provided compelling reasons to integrate ESG principles in the way we operate. Emphasizing the importance of ESG principles, 181 top global CEO’s signed in August 2019 a mission “Statement on the Purpose of a Corporation”² committing to deliver value for each of the stakeholders if businesses were to flourish.

The recent COVID-19 pandemic crisis has not only been deemed as the greatest recession since World War II but has also served as a wake-up call for businesses to manage their black swan events. With the number of COVID cases crossing 67 million, the global economies have been hit hard by sweeping shutdowns to check the spread of the disease. Due to this impact, many investors and policymakers are viewing this as an alarm to adopt a different approach to investing as many parallels have been drawn between the unanticipated risk of the pandemic and climate change.

During the initial days of spread of the pandemic, it appeared that environmental and sustainable finance topics might take a back seat as a global recession loomed large on the horizon. On the contrary, major ESG funds outperformed indices like the S&P 500³ during the first few weeks of the pandemic and many ESG funds could palliate the diminishing value vis-à-vis their non-ESG counterparts. This provided a ray of hope towards the potential of ESG in mitigating the adverse impacts of the unprecedented pandemic and better cushion the spread of the disease.


### Top 5 Global risks in terms of likelihood

<table>
<thead>
<tr>
<th>Year</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>2017</td>
<td>Extreme Weather events</td>
<td>Large scale involuntary migration</td>
<td>Major natural disasters</td>
<td>Large scale involuntary migration</td>
<td>Massive incident of data fraud/theft</td>
</tr>
<tr>
<td>2018</td>
<td>Extreme Weather events</td>
<td>Natural disasters</td>
<td>Cyber attacks</td>
<td>Data fraud or theft</td>
<td>Failure of climate change mitigation and adaptation</td>
</tr>
<tr>
<td>2019</td>
<td>Extreme Weather events</td>
<td>Failure of climate change mitigation and adaptation</td>
<td>Natural disasters</td>
<td>Data fraud or theft</td>
<td>Human made environmental disasters</td>
</tr>
<tr>
<td>2020</td>
<td>Extreme Weather events</td>
<td>Failure of climate change mitigation and adaptation</td>
<td>Natural disasters</td>
<td>Biodiversity loss</td>
<td>Failure of climate change mitigation and adaptation</td>
</tr>
</tbody>
</table>

### Top 5 Global risks in terms of impact

<table>
<thead>
<tr>
<th>Year</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>2017</td>
<td>Weapons of mass destruction</td>
<td>Extreme Weather events</td>
<td>Water crises</td>
<td>Major natural disasters</td>
<td>Failure of climate change mitigation and adaptation</td>
</tr>
<tr>
<td>2018</td>
<td>Weapons of mass destruction</td>
<td>Extreme Weather events</td>
<td>Natural disasters</td>
<td>Failure of climate change mitigation and adaptation</td>
<td>Extreme Weather events</td>
</tr>
<tr>
<td>2019</td>
<td>Weapons of mass destruction</td>
<td>Failure of climate change mitigation and adaptation</td>
<td>Extreme Weather events</td>
<td>Water crises</td>
<td>Extreme Weather events</td>
</tr>
<tr>
<td>2020</td>
<td>Failure of climate change mitigation and adaptation</td>
<td>Water crises</td>
<td>Natural disasters</td>
<td>Water crises</td>
<td></td>
</tr>
</tbody>
</table>

Categories: Economic | Environmental | Geopolitical | Social | Technological

Source: Global Risk Report 2017-20, WEF

Risk, returns and resilience: Integrating ESG in the financial sector
investment ecosystem from future uncertainty. Many investors are also re-evaluating both short-term and long-term portfolio strategies and businesses are assessing their priority on sustainability. High social standards and strong corporate governance mechanisms have been the most talked-about topics in the investor community in order to take decisions that are resilient against the pandemic’s impact.

Companies that are more strategically and operationally resilient, that treat their workforces better will likely be more attractive to investors. This calls for companies to integrate ESG investor expectations in the short-term as a part of their stakeholder engagement practices and sustainability initiatives to stay more resilient. However, the industry response to the current pandemic gives rise to a better understanding of the ESG impacts on businesses in the long-term. For example, many investors have failed to model the social aspects of ESG in their due diligence process (the environmental aspects being more quantifiable), this gives an opportunity to understand the financial implications of major social disruptions. This, in turn, would result in a more mature approach by corporates towards integrating the ESG investor expectations in their businesses.

Amidst the uncertainty posed by the pandemic, there lies an enormous challenge to reach the 2030 Agenda for Sustainable Development*. The world has moved into the final decade for achieving the Sustainable Development Goals (SDG’s). As per an estimate by United Nations Conference on Trade and Commerce (UNCTAD), the total investments in SDG-relevant sectors in developing economies will need to be in between US$3.3t and US$4.5t. This indicates that there is an annual financing gap of some US$2.5t between current funding and what is required. Both the public and private sectors will play a fundamental role in financing the SDG’s. While the public sector clearly dominates the infrastructure investments in Low- and Middle-Income Countries (LMIC’s), an increased participation by the private sector could help close the gap in the SDG financing. Thus, the financial sector with the integration of ESG issues will act as a catalyst and pivotal engine in driving the much-needed capital towards financing the 2030 SDG targets.

ESG challenges, such as climate change, have profound implications for businesses, the economy and society at large, thus offering opportunities for both, the society and businesses, to achieve long-term economic and social growth.

Sandip Khetan
Partner and National Leader
FAAS, EY India


Risk, returns and resilience: Integrating ESG in the financial sector
The State of Play: Need for Risk Management, Returns and Resilience
Increasing in number and speed, ESG issues are becoming financially material. Thirty years ago, when climate change was established as a scientific fact, most investors did not consider it as a substantial investment risk. Today, considering mounting evidence, activism and regulation, investors are including climate considerations in their investment decision making. For example, a group of investors managing US$118t in assets now expects companies to provide disclosures in accordance with the Task Force on Climate related Financial Disclosures (TCFD). While getting to this point took decades, the pace of change has accelerated. This is equally true for social issues, which almost 50% of investors believe will have a significant impact on share prices within the next 24 months. Investors are trying to build capabilities which will enable them to create sustainable investing strategies, aided by the growing risk and opportunities provided by sustainability trends for companies to create long-term value. They are also putting in efforts to successfully anticipate how such ESG issues will become financially material either for a particular company or an industry.

There is a rapidly growing perception that value extends beyond pure financial returns in the minds of investors. By tying finance to sustainable business models, i.e., those that avoid contributing to climate change, pollution, environmental degradation and labor abuses, banks and investors can reduce the negative ESG exposure of their lending and investment portfolios and encourage more responsible business practices. This, in one way, is encouraging businesses to become more resilient towards the ESG related risks if they want to attract investor capital. The financial sector has now become a hotspot for driving ESG integration into businesses. Investment risk is rapidly becoming a major ESG focus theme. With an increase in natural disasters caused by climate change, potentially disruptive green swan events will become relevant to all businesses. Asset owners now routinely require a credible articulation of how ESG principles are being embedded within individual asset class strategies. Retail investors are also increasingly focused on incorporating sustainability strategies into their investment portfolios. In addition to the massive surge in Exchange Traded Fund (ETF) inflows, ultra-high net worth investors are demanding the implementation of ESG metrics into their private portfolios. Wealth management clients are a fast-growing segment of ESG investors, accounting for a significant portion of new accounts. There is especially strong demand arising out of the millennials who are more conscious when it comes to making investment decisions. The recent COVID-19 pandemic has witnessed rising fortunes for ESG investing.

Green swans, or “climate black swans”, present many features of typical black swans. Climate-related risks: both physical and transition risks are characterized by deep uncertainty and non-linearity, their chances of occurrence are not reflected in past data and the possibility of extreme values cannot be ruled out (Weitzman (2009, 2011)). Hence, traditional risk management approach of extrapolating historical data to assess future climate risks will not serve the purpose. That is, assessing climate-related risks requires an “epistemological break” (Bachelard (1938)). However, green swans are different from black swans in three regards. First, although the impacts of climate change are highly uncertain, “there is a high degree of certainty that some combination of physical and transition risks will materialize in the future” (NGFS (2019a), p 4). That is, there is certainty about the need for ambitious actions despite prevailing uncertainty regarding the timing and nature of impacts of climate change. Second, climate catastrophes are even more serious than most systemic financial crises: they could pose an existential threat to humanity, as increasingly emphasized by climate scientists (e.g., Ripple et al (2019)). Third, the complexity related to climate change is of a higher order than for black swans: the complex chain reactions and cascade effects associated with both physical and transition risks could generate fundamentally unpredictable environmental, geopolitical, social and economic dynamics.

Source: https://www.bis.org/publ/othp31.pdf

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1 The TCFD develops voluntary, consistent climate related financial risk disclosures for use by companies in providing information to stakeholders.
According to research firm Morningstar, investors have globally poured in US$45.6b into ESG funds in the first quarter of the year, compared to outflows of US$384.7b for the overall fund universe.

S&P Global Market Intelligence analyzed 17 exchange-traded and mutual funds with more than US$250m in assets under management that select stocks for investment based in part on ESG criteria. Of those funds, 12 have lost less value so far this year than the S&P 500.

Several ESG funds outperforming the S&P 500 in 2020

<table>
<thead>
<tr>
<th>YTD price change(%)</th>
<th>Fund (ticker)</th>
</tr>
</thead>
<tbody>
<tr>
<td>−5.4</td>
<td>Brown Advisory Sustainable Growth Fund (BA FWX)</td>
</tr>
<tr>
<td>−7.4</td>
<td>Nuveen Winslow Large-Cap Growth ESG Fund (NV LIX)</td>
</tr>
<tr>
<td>−10.7</td>
<td>Green Century Equity Fund (GCEOX)</td>
</tr>
<tr>
<td>−10.7</td>
<td>Putnam Sustainable Leaders Fund (PNOPX)</td>
</tr>
<tr>
<td>−11.2</td>
<td>iShares MSCI USA ESG Select ETF (SUSA)</td>
</tr>
<tr>
<td>−11.9</td>
<td>Parnassus Core Equity Fund (PRBLX)</td>
</tr>
<tr>
<td>−12.1</td>
<td>Calvert US Large-Cap Core Responsible Index Fund (CSXAX)</td>
</tr>
<tr>
<td>−12.5</td>
<td>iShares ESG MSCI USA ETF (ESGU)</td>
</tr>
<tr>
<td>−12.7</td>
<td>SPDR S&amp;P 500 Fossil Fuel Reserves Free ETF (SPYX)</td>
</tr>
<tr>
<td>−12.9</td>
<td>Vanguard ESG U.S. Stock ETF (ESGV)</td>
</tr>
<tr>
<td>−13</td>
<td>Ave Maria Growth Fund (AVEGX)</td>
</tr>
<tr>
<td>−13</td>
<td>American Century Sustainable Equity Fund (AFDAX)</td>
</tr>
<tr>
<td>−13.7</td>
<td>S&amp;P 500</td>
</tr>
<tr>
<td>−13.8</td>
<td>TIAA-CREF Social Choice Equity Fund (TISCX)</td>
</tr>
<tr>
<td>−14.2</td>
<td>Vanguard FTSE Social Index Fund (VFTNX)</td>
</tr>
<tr>
<td>−15.3</td>
<td>Neuberger Berman Sustainable Equity Fund (NBSLX)</td>
</tr>
<tr>
<td>−16.4</td>
<td>DSA U.S. Sustainability Core 1 Portfolio (DFSIX)</td>
</tr>
<tr>
<td>−17.8</td>
<td>Parnassus Endeavour Fund (PARNX)</td>
</tr>
</tbody>
</table>

Data Compiled April 10, 2020
Analysis limited to select U.S. equity ESG exchange-traded funds and mutual funds, with more than US$250 million in assets under management including all share classes
Price change measured from Dec 31, 2019 to Apr 9, 2020

Source: S&P Global Market Intelligence

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In today's transformative world, disruption in businesses has become a major challenge for governments, society and companies to manage. In such a scenario there is an increasing thrust from market participants on companies to create long-term value for multiple stakeholders. A migration in opinion that a company's primary objective is to protect the shareholder value (shareholder capitalism), to a view that businesses are better able to deliver long-term value to the shareholders when they cater to the needs of all their stakeholders like customers, employees, investors and regulators (stakeholder capitalism) is observed. The boards are expected to understand the needs and demands of the key stakeholders to deliver long-term value. Further to this point of view, the boards must consider how a company's value in intangible assets such as culture, human capital, corporate governance, innovation and ESG initiatives can be reflected. Many institutional investors are of the opinion that corporate balance sheets may not completely reflect the value of intangibles which leads to inappropriate market capitalization of a firm. Investors are demanding companies to disclose how they identify and measure intangible assets as well as the ESG initiatives that impact long-term value creation.
The world’s largest institutional investors have explicitly expressed their belief that companies need to take a long-term view and embrace stakeholder capitalism as the best path to value creation.

Source: https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter

As per a survey by EY, only 25% of the investors believe that the current financial reporting clearly conveys how a company can create future value through its investments. Thus, it is imperative for companies to focus on the non-financial reporting aspects as well which serves a wider range of stakeholders. Transparency in reporting non-financial material issues will enable companies to create long-term value, foster confidence amongst the investor community and mitigate the risks that threaten their operations in an efficient way.

The evolving concept of ESG is now overlapping with fiduciary duty

Climate-related financial risks pose an imminent threat: the frequently occurring abnormal weather events like droughts, floods and wildfires will lead to economically devastating consequences in the long run. Rising temperatures will bring down productivity and lower agricultural yields, rising sea levels will destroy coastal properties leading to higher insurance premiums. The market players are cognizant of this. Contrary to the earlier belief that considering ESG factors in investment due-diligence process calls for a trade-off with returns, investors are constantly looking for responsible investment opportunities. They now believe it will result in long-term returns.

As the outlook of businesses migrates from the short-term gains to the concept of long-term value creation for stakeholders, ESG integration is the fiduciary duty of the asset managers and those responsible for managing other people’s money. The fiduciary duty exists to ensure that those responsible for investments act in the interest of the beneficiaries, rather than serving their own interests. For companies to be able to perform their fiduciary duties towards the stakeholders and curb corporate governance issues, the role of independent directors in the board composition is vital. With regulations mandating the appointment of independent directors to a company’s board, the concept of long-term value creation has been reinstated as these independent directors act as conscience-keepers steering the company in the right direction.

Intangible assets represented 17% market value in 1975, having risen (in some sectors) to 87% by 2015

– The Institute of Chartered Accountants in England and Wales (ICAEW), 2017
**Stewardship focus**

Since the 2008 financial crisis, there has been a changing expectation of the market participants on issues such as corporate governance and an increasing belief that governance should be serving a wider range of stakeholders. This change for the investor community is reflected by the increasing number of stewardship codes, guidelines and principles that have been adopted across the globe. These stewardship codes are guidance on how the investors should discharge their ownership and governance responsibilities and engage with the investee companies.

In 2010, the UK became the first jurisdiction to adopt a stewardship code followed by Denmark, Hong Kong, Japan, Kenya, Malaysia, South Africa, Taiwan and Thailand. More recently, the European Union (EU) adopted a Shareholders Rights Directive that includes elements found in existing stewardship codes and India and Kazakhstan are actively considering the adoption of stewardship codes or similar initiatives. Investor-led best practice guidance currently exists in Australia, Brazil, Canada, Italy, the Netherlands, Singapore, South Korea, Switzerland and the United States (US). In addition, the International Corporate Governance Network (ICGN), whose members represent governance professionals from over 47 countries, adopted Global Stewardship Principles in 2016.

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8 In April 2017, the European Council adopted a revised Shareholders Rights Directive. New measures include a requirement for institutional investors to publicly disclose their policy for how they integrate shareholder engagement in their investment strategies or explain why they have chosen not to do so.

9 Members of certain membership bodies or associations may also need to adhere to stewardship standards. In Australia, compliance with the Financial Services Council’s (FSC) Standards is compulsory for all full FSC members and the FSC has recently developed a new standard focused on internal governance and asset stewardship.
The push and pull of the regulatory landscape
ESG investing is a 21st century phenomenon, with 48 of the top 50 economies, having some form of policy to help investors manage ESG risks, opportunities or outcomes.¹⁰ There are signs that momentum is being maintained for collaboration as BlackRock, one of the world’s largest investors in banks and fossil fuel companies, has recently been hired by the European Union to study how the bloc can integrate ESG factors into its banking supervision.¹¹ The Business Roundtable has asked the US government to protect workers and help keep businesses afloat during the coronavirus crisis.¹²

The ESG regulatory landscape has been shaped by recent activities in the US, the EU and the UK. Some of the key regulations across the geographies are:

<table>
<thead>
<tr>
<th>Geography</th>
<th>Disclosure, Effective Year</th>
<th>Institution</th>
<th>Summary of requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canada</td>
<td>TSX Listing Rules, 2014</td>
<td>TSX</td>
<td>Any environmental or social information deemed ‘material’ must be immediately disclosed by a news release as required by the Exchanges’ Timely Disclosure Policies and F17 report on SEDAR</td>
</tr>
<tr>
<td>Canada</td>
<td>Disclose climate impacts to qualify for COVID-stimulus funds, 2020</td>
<td>Government of Canada</td>
<td>Large Employer Emergency Financing Facility (LEEFF) for Canadian businesses seeking relief-package to weather the economic downturn and bankruptcies. The companies must commit to publishing climate-related disclosure reports in accordance with TCFD.</td>
</tr>
<tr>
<td>EU</td>
<td>The Taxonomy Regulation, 2021</td>
<td>European Council</td>
<td>Aims to introduce an EU-wide classification system (i.e. a taxonomy) for ESG-related investments, was adopted by the European Council on 15 April 2020 with the aim of establishing the taxonomy by the end of 2020 and full application by the end of 2021.</td>
</tr>
<tr>
<td>EU</td>
<td>&quot;Disclosure Regulation&quot;, 2021</td>
<td>The European Parliament and of the Council</td>
<td>Prescribes disclosures to be made by asset managers and investment funds relating to sustainable investments and sustainability risks from 31 March 2021.</td>
</tr>
<tr>
<td>EU</td>
<td>Amendment to Regulation (EU) 2016/1011 as regards EU Climate Transition Benchmarks and EU Paris-aligned Benchmarks, 2019</td>
<td>European Union</td>
<td>Introduces a regulatory framework which lays down minimum requirements for EU Climate Transition and EU Paris-aligned Benchmarks at Union level.</td>
</tr>
<tr>
<td>EU</td>
<td>Amendment to Regulation (EU) 2017/2359 as regards the integration of ESG considerations and preferences into the investment advice for insurance-based investment products, 2018</td>
<td>European Union</td>
<td>Provides for an updated harmonized legal framework governing the requirements applicable to the distribution of insurance-based investment products.</td>
</tr>
</tbody>
</table>

¹¹ https://www.theguardian.com/business/2020/apr/12/blackrock-eu-environmental-rules-for-banks
¹² https://www.businessroundtable.org/covid-19
<table>
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<th>Institution</th>
<th>Summary of requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>France</td>
<td>Loi Energie et Climat, 2020</td>
<td>Gouvernement de la République française</td>
<td>This legislation will be updating the requirements set out in the 2015 Energy transition law. It includes an update of Article 173, of the low carbon targets, etc.</td>
</tr>
<tr>
<td>Germany</td>
<td>Insurance Supervision Act - Occupational Pension Schemes - Section 115 (4)</td>
<td>BaFin</td>
<td>Pension funds must issue a statement to their beneficiaries disclosing if and how ESG factors are taken into consideration in the investment process.</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>Corporate Governance Code, 2019</td>
<td>Hong Kong Securities Exchange (HKEX)</td>
<td>Issuers are expected to comply with, but may choose to deviate from, the code provisions, but must state whether they have complied with the code provisions in annual reports.</td>
</tr>
<tr>
<td>India</td>
<td>Business Responsibility and Sustainability Report (BRSR), 2020</td>
<td>Republic of India, Ministry of Corporate Affairs</td>
<td>Recommends a new two-format reporting framework which provides guidelines for the preparation of BRR for listed and unlisted companies in India, takes into consideration the global developments in non-financial sustainability reporting, which increasingly require businesses to be responsible and sustainable towards the environment and society.</td>
</tr>
<tr>
<td>India</td>
<td>Companies Act 2013, 2014</td>
<td>Republic of India, Ministry of Corporate Affairs</td>
<td>Improves government oversight of companies and its section 135, requires listed companies that have a) a net worth of five hundred crore rupees or more, b) turnover of one thousand crore rupees, or c) an Average Net profit of five crore rupees for the preceding three years to produce a CSR report. Additionally, it requires the inclusion of at least one woman on the boards of listed companies.</td>
</tr>
<tr>
<td>New Zealand</td>
<td>Mandatory TCFD-based reporting, 2023</td>
<td>Government of New Zealand</td>
<td>Requires all banks, asset managers and insurance companies with more than NZ$1 billion in assets to disclose their climate risks, in line with the emerging global standard from the TCFD</td>
</tr>
<tr>
<td>Singapore</td>
<td>Listing Rule, 2016</td>
<td>SGX</td>
<td>SGX requires listed issues to prepare an annual sustainability report on a comply-or-explain basis, the report should at minimum address how material ESG factors are selected, set out the policies, practices and performance related to these factors, identify targets, and include a statement from the board.</td>
</tr>
<tr>
<td>South Africa</td>
<td>Mandatory integrated reporting, 2009</td>
<td>&quot;Johannesburg Stock Exchange (JSE)&quot;</td>
<td>Introduction of mandatory integrated reporting in 2009, for companies listed on the Johannesburg Stock Exchange (JSE)</td>
</tr>
<tr>
<td>Geography</td>
<td>Disclosure, Effective Year</td>
<td>Institution</td>
<td>Summary of requirement</td>
</tr>
<tr>
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</tr>
<tr>
<td>UK</td>
<td>The Occupational Pension Schemes (Investment) Regulations, 2019</td>
<td>UK Pensions Regulator</td>
<td>Pension funds’ Statement of Investment Principles must cover financially material issues including ESG, a stewardship policy and the extent to which (if at all) members' views are taken into account.</td>
</tr>
<tr>
<td>UK</td>
<td>Changes to the Companies Act 2006 (Strategic report and Directors' Report), 2013</td>
<td>UK Government, the Department for Business, Innovation and Skills (BIS)</td>
<td>Mandatory GHG reporting (Part 7: Disclosures concerning Greenhouse Gas Emissions) human rights and diversity by all listed companies in Director's report.</td>
</tr>
<tr>
<td>USA</td>
<td>US SEC Climate Guidance, 2010</td>
<td>Securities and Exchange Commission (SEC)</td>
<td>Publicly traded companies are required to transparently disclose material business risks to investors through regular filings with the Securities and Exchange Commission (SEC), including, business risk posed by climate change developments</td>
</tr>
</tbody>
</table>

(For detailed reference to the regulations, refer to the Appendix)

Although various voluntary disclosure frameworks like GRI, SASB, TCFD, OECD, CDP, etc. have been adopted by financial services sector companies for their ESG disclosures, initiatives by organizations like IOSCO, IFAC and WEF have been aimed at formulating standardized disclosures by financial institutions on ESG parameters. IOSCO has established a Board-level Task Force on Sustainable Finance\(^{13}\) aimed at improving sustainability-related disclosures made by issuers and asset managers; collaboratively work with other international organizations and regulators to avoid duplicative efforts and to enhance coordination of relevant regulatory approaches; and to conduct analysis for improving transparency and other investor protection issues. The IFAC calls for the creation of a new International Standards Sustainability Board\(^{14}\), alongside the IASB, to develop global standards and rationalize the current fragmented ecosystem of sustainability-related reporting. Meanwhile, WEF has published a report\(^{15}\) that proposes a common, core set of metrics and recommended disclosures for International Business Council members to align their mainstream report which will reduce fragmentation and encourage the progress towards a generally accepted international accounting standard on ESG disclosures. EY has been a collaborator to WEF on this report.

As a result of increased regulatory pressure, subject-matter experts at EY India’s Climate Change and Sustainability Services anticipate that asset managers and financial intermediaries would increasingly seek to obtain and analyze ESG-related data from companies in which they invest, directly or indirectly. Publicly traded companies would be expected to provide more ESG-related disclosure. As a result, there likely will be an increased demand for ESG data from across the business value chain.

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\(^{13}\) Sustainable Finance and the Role of Securities Regulators and IOSCO, FR04/2020, April 2020

\(^{14}\) https://www.ifac.org/knowledge-gateway/contributing-global-economy/discussion/enhancing-corporate-reporting-way-forward

\(^{15}\) Toward Common Metrics and Consistent Reporting of Sustainable Value Creation, January 22, 2020; http://www3.weforum.org/docs/WEF_IBC_ESG_Metrics_Discussion_Paper.pdf
Decoding E-S-G
In the past two-three years, the world has witnessed a shift and growth in the adoption of ESG investing and mainstreaming and maturing of responsible investment practices. While there is still a long way to go, the investor community has witnessed a shift in focus from a pure risk-return standpoint to giving importance to actual real-world social outcomes. The COVID-19 crisis, which has swept the world, has further established this belief proven by the increased inflow in the ESG related funds in the first half of 2020. This pandemic has validated the fact that sustainability does not come at a cost, but more than that can future-proof investments and in certain cases, can boost returns as well. 2020 will go down in history as the year for ESG factors cementing their position as a commanding and enduring feature across the financial services landscape.

The hallmark of sustainable finance is the integration of ESG factors in the fabric of a financial institution, from strategy to investments, credit offerings to risk mitigation and finally to external communication and reporting. ESG risks cover a wide range of issues ranging from a company’s response to climate change, to the promotion of ethical labour practices, to issues around data privacy and governance. The number of investors, both institutional and retail and in developed and emerging markets alike, who consider ESG risks as a screening test for their portfolio companies, have been on the rise.

Decoding “E”: Environment

The environmental factors refer to how an organization operates within the physical, natural environment. Businesses today are exposed to several environmental risks due to the ever-increasing threats posed by climate change. These include catastrophic weather events, water scarcity, rising global temperatures, water scarcity and ecological breakdown. The TCFD has divided them into two sub-groups:

- Physical risks, which include the direct financial and operational implications for organizations or sovereigns from natural catastrophes, but also long-term climate change; and
- Transition risks, which include all the policy, legal, technological, and reputational challenges from the transition to a low-carbon economy and their associated costs.

While this has an implication on a company’s competitive positioning and can asphyxiate economic opportunities, businesses cannot shy away from acknowledging the role that they can play in combating these environmental risks. Investors are now increasingly considering the impact a business has on the environment and conversely how the businesses are impacted by the environmental risks. The environmental aspect of ESG includes investors examining a company’s natural resource usage, and the impact of its operations and value chain on the environment, including through resource use and carbon emissions. But the business case for embracing integration of E factors in investment decisions is not only about risk management. The move towards more sustainable business models translates to concrete opportunities for companies to become more innovative and reduce the high costs of production and waste management.

Decoding “S”: Social

The social factors refer to how businesses impact their stakeholders – customers, employees and communities in which they operate. It includes the risk of violation of human rights of the stakeholders: limiting freedom of association would result in a direct negative impact on the workers’ rights. Other examples include discrimination based on gender and ethnicity when hiring or promoting employees in an organization; failure to monitor the suppliers with respect to paying a living wage to their workers; investing in businesses and sectors with severe health implications on those employed. From investors’ point of view, managing social risk means understanding which stakeholder groups are impacted as a result of the lending or investing activity, and assessment of the extent to which these stakeholders will be negatively impacted as a result of poor corporate practices.

Social issues, just like the environmental issues, present opportunities for both, investors and the companies. According to the UNPRI, one of the sectors that will be pivotal for achieving the SDGs while driving business savings and revenues is health and well-being. Healthcare sector, once considered a niche for impact investors, has gradually become appealing to the mainstream investors. The sector, although large and diverse, has one thing in common across all its sub-sectors and that is the potential to generate robust investment returns along with generating positive social impact. These include traditional investments in physical infrastructure of hospitals and clinics catering to the emerging middle-class in emerging markets, also in projects providing access to healthcare facilities for the poor communities. Such wide variety of options available in the healthcare sector provides the investors with an opportunity to diversify their investment portfolio as well as to balance their risks and returns.

Decoding “G”: Governance

The governance issues include two core components: corporate governance and business integrity. The first can be considered as the way a company governs itself through policies, processes and controls to achieve compliance and how transparent a company is in its operations. Business integrity deals with how a company resolves issues like corruption and bribery and avoids engaging with politically exposed people who may risk
a company’s brand reputation. The financial services industry has been considering governance issues for over 25 years now and market trends suggest that good governance practices lead to high returns. It is less likely that a business with transparent and ethical business practices will be caught in scandals related to environmental and social issues and such businesses will likely act keeping in mind the long-term threats.

It is believed that a diverse board structure can have a huge impact on the governance of an organization. The issues, such as climate change, arising today are so complex in nature that it is believed that having people with different background and diverse experience will help in improving the decision-making process of companies.

<table>
<thead>
<tr>
<th>Environmental</th>
<th>Social</th>
<th>Governance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Climate change</td>
<td>Human capital</td>
<td>Corruption and bribery</td>
</tr>
<tr>
<td>Carbon emissions</td>
<td>Labour standards</td>
<td>Business ethics</td>
</tr>
<tr>
<td>Water stress</td>
<td>Human rights</td>
<td>Board play</td>
</tr>
<tr>
<td>Renewable energy</td>
<td>Privacy and data security</td>
<td>Board diversity</td>
</tr>
<tr>
<td>Natural capital</td>
<td>Community engagement</td>
<td>Ownership</td>
</tr>
</tbody>
</table>
Financial sector through the ESG lens
The COVID-19 pandemic has de-shaped the global economy in a span of weeks. There has been a shift in focus of many businesses and investors from profits to people as the pandemic unrolled; the most concerning issue globally was the safety of the people. Issues like access to healthcare and societal welfare were topping the list globally. It soon became an established fact that environmental and social issues have a profound and direct impact on economic stability. The transmittance of this instability has affected the carbon economy the most. Oil prices hit an all-time low, the demand for oil also plummeted. Industries intensive on carbon — from airlines to mining to steel — all were either shut or were forced to reduce their operations drastically. For some time, the sustainability agenda was pushed to the backseat by the ongoing economic and health crisis. However, it is believed that in the post-pandemic era, the ESG factors will remain central to driving the economy upwards.

**The rise of ESG**

Globally, there has been an increase in the number of retail and institutional investors that apply ESG principles to their portfolios. At the same time, there has been a shift in the mindset of employees as well. People today want to work for companies that have a purpose and are clear on the idea of sustainability. Businesses that have adopted this approach clearly have a competitive advantage in attracting and retaining the best people as their workforce.

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Findings from EY’s Global Investor Survey, covering views of ~ 300 institutional investors on Environmental Social and Governance (ESG) performance, show a clear trend towards increasing integration of sustainability or non-financial factors in investment decisions.

![Image](https://www.investmentexecutive.com/inside-track_/dustyn-lanz/esg-and-covid-19-four-market-trends/)

**Source:** EY Investor Survey Report, 2020

As most nations unlock themselves and begin to take a step towards the new normal, it is expected that policy makers, regulatory bodies and authorities will articulate the need to adopt ESG. In addition to this, these bodies also acknowledge the fact that adoption of ESG will create additional complexities for financial services firms. They are also skeptical that the financers, i.e., the banks are ill-prepared to conduct thorough due-diligence and risk assessment for the threats posed by direct risks (the physical impact of climate change on assets) and the transition risks (impact in moving towards a low-carbon economy). The banks face additional pressure from the investors because ESG factors, climate change in particular, pose mammoth risks which must be mitigated. Investors, at the same time, also want to ensure healthy returns on their investments. Interestingly, recent data suggests that ESG-related funds outperformed the markets over the first quarter of the year – when the COVID-19 economic crisis started. The MSCI World ESG Leaders Index, for example, outperformed the regular index by 1.36% on the quarter. According to Morningstar, 70% of responsible investment funds outperformed their peers in the first quarter."

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Stranded assets

Assets that have suffered from unanticipated or pre-mature write downs, devaluations or conversion to liabilities. In the case of stranded fossil-fuel assets, the devaluation would primarily be driven by climate policy, from country-level targets to sector policies meant to drive the transition to low-carbon

Source: Divestment and Stranded Assets in the Low-carbon Transition, Background paper for the 32nd Round Table on Sustainable Development 28 October 2015

ESG in banking

Leading global corporates, the UN, OECD, the G20, certain regulators and investors hold the opinion that environmental and social issues must be considered in investment decisions and corporate decision-making processes, along with the traditional financial metrics.

Banks are the locus of financial-stability and economic development of a nation. In order to efficiently play its role in today’s evolving times, the banking sector needs to significantly change its actions and attitude to promote more responsible and sustainable business practices.

The UN PRI- an investor initiative in partnership with UNEP-FI and UN Global Compact – has seen its signatories rising from 100 to over 3,000 since it began in 2006.

ESG challenges like the climate change has profound implications for businesses, the economy and society at large, thus offering both challenges and opportunities if long-term economic and social growth and stability are to be achieved. These ESG challenges have remarkable relevance to the banks in particular because of their role as financial intermediaries and capital raising agents. The banks, in their capacity as catalysts in promoting economic development, must encourage sustainable business practices. If they fail to do so, the banks may end up facilitating practices that have significant negative environmental and social impacts, including the risk of stranded assets. The banks, through their operations in emerging markets, act as drivers for growth and development. ESG risks and issues are more prevalent as such markets are immature in robust and comprehensive regulations, weaker enforcement and lower awareness and capacity, amongst all stakeholders, regarding ESG issues. However, these emerging markets, home to the fastest growing economies and populations in the world and containing vast reserves of natural resources, bring forth subsequent risk and opportunities for banks to create innovative products and services that have a positive social impact.
Banks as levers to accelerate the transition towards a low-carbon economy

The ever-increasing greenhouse gas (GHG) emissions are warming the planet, causing climate change and are constantly posing a threat to human life. The current trends suggest a 1°C warming above pre-industrial levels.\(^\text{17}\)

Seventy percent of the abnormal weather events recorded since 2012\(^\text{18}\) can be attributed to climate change and insured losses from events like natural disasters have been on the rise. Such abnormalities are expected to be the norm in near future. Without immediate action, the world is on course to reach 2°C by 2050 and 3.2°C by 2100\(^\text{19}\) leaving populations exposed to water scarcity and compounding annual flood damage losses from sea level rise. Avoiding such catastrophic circumstances require deep and sustained cuts in GHG emissions. This transition to a low-carbon economy can only be facilitated by a transformation of assets and behavior for which trillions of dollars of financing is required.\(^\text{20}\)

Banks can become an active part of this transition to a low-carbon economy by adopting a strategic approach at the board level and allocate resources to build the business case and competence for sustainable finance. Banks with this strategy can serve the clients of the future successfully by generating a pipeline for green finance, avoid risks, generate returns and maintain their social license to operate. By competence building it is intended that a bank empowers the risk management function to understand and quantify climate-related sources of physical and transition risk into the mainstream risk assessment framework. A shared-value approach, where the bank shares a vision of a low-carbon future with the clients and further connects the clients with the experts and the tools required to realize that vision, can prove to be pivotal in bringing about this transition. The transforming role lies in the bank’s ability to find or innovate ways of securing capital at a rate that makes investment in low carbon assets or operating models more attractive to the clients. The source of capital can be development finance community, philanthropic sources, international aid, support from domestic governments or capital markets. The bank can leverage its unique position- its understanding of the client, its position in the network of economy as an intermediary and its ability to design financial instruments. The capital can also come from the bank’s balance sheet if the overall risk/return objective is aligned with the strategic intent and sector tolerances of the bank.

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20 Campiglio,E.,Beyond carbon pricing: the role of banking and monetary policy in financing the transition to a low-carbon economy. Ecological Economics, (pp. 121, 220-230)
ESG in asset management

The COVID-19 pandemic has served as a testbed with sustainable investments outperforming their conventional counterparts in the first quarter of 2020 even when the markets were sent crashing by the outbreak. In the wake of instability, there lies a great opportunity for experimentation and innovation. As most clients are anxious and vulnerable in the pandemic-hit world, value can be derived by providing them with solutions that have a deeper sense of purpose. There is an ever-increasing scrutiny of investors now on the type of companies they are investing in, how these companies support their customers, employees and other stakeholders in times of crisis. As the world marches into the new normal, asset managers can leverage this opportunity by embracing ESG integration and stepping up the game rather than getting wiped out by continuing with the business as usual tactics.

As we progress into the new normal, there lies an opportunity for the asset managers to seamlessly incorporate high-quality ESG data into their investment processes. This will be fueled by the fact that the corporate goals of profitability and social usefulness are no longer mutually exclusive. As more young and socially conscious investors begin to invest, the demand for ESG products will not remain cyclical but rather be governed by the radical shift in the consumer preferences. Despite increased publicity around ESG products and numerous product launches, AUM remains small as a percentage of overall invested assets. According to a report by Moody’s Investor Service²¹, ESG penetration averaged 6.5%, while the median penetration was 1.8% in a US$89 trillion market formed by the signatories of UN PRI.

An emerging opportunity lies in the real estate and infrastructure sector where REITs (Real Estate Investment Trusts) and InvITs (Infrastructure Investment Trusts)²² are gaining significant popularity among issuers and institutional investors. According to the UN Environment Programme, the construction and operations of buildings account for 40% of global energy use, 30% of energy related GHG emissions, approximately 12% of water use, nearly 40% of waste, and employs 10% of the workforce.

Construction processes are very energy intensive and generate a lot of emissions. Hence, there lies immense opportunity to improve performance of buildings on ESG parameters through GHG reduction in cradle-to-cradle design for business supply chains, investments and resource use priorities. In addition, addressing the ESG issues could provide a market price premium, lower risk of default, lower volatility and a slower rate of depreciation. In the US, most publicly owned buildings are listed, and the stocks are held by REITs allowing investors to influence management towards incorporating sustainability-focused policies and practices. Most REITs focus on sustainability as profit drivers by means of: (i) cost reductions through energy efficiency, (ii) increasing rents and values through sustainable certifications of buildings.

<table>
<thead>
<tr>
<th>Common examples of ESG Incorporation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Positive/best-in-class screening</td>
<td>Investment in sectors, companies or projects selected for positive ESG performance relative to industry peers. This also includes avoiding companies that do not meet certain ESG performance thresholds.</td>
</tr>
<tr>
<td>Negative/exclusionary screening</td>
<td>The exclusion from a fund or plan of certain sectors or companies involved in activities deemed unacceptable or controversial</td>
</tr>
<tr>
<td>ESG integration</td>
<td>The systematic and explicit inclusion by investment managers of ESG factors into financial analysis</td>
</tr>
<tr>
<td>Impact investing</td>
<td>Targeted investments aimed at solving social or environmental problems</td>
</tr>
<tr>
<td>Sustainability themed investing</td>
<td>The selection of assets specifically related to sustainability in single or multi-themed funds</td>
</tr>
</tbody>
</table>

Source: US SIF

²¹ Beyond passive, ESG investing is the next growth frontier for asset managers, Moody’s Sector in Depth Asset Managers Global, February 27, 2020
²² REITs and InvITs are innovative vehicles that enable developers to monetize their revenue-generating real estate/infrastructure assets and release capital for funding new infrastructure/real estate projects. REITs/InvITs allow investors to invest in these assets without owning them. Since the units of the trusts are listed on the stock exchanges, they also provide liquidity to investors in an otherwise largely illiquid asset class.

Risk, returns and resilience: Integrating ESG in the financial sector
ESG in insurance

The insurance business revolves around the aggregation, management and transference of risk. Insurance companies take the risk of their customers in return for a premium and manage that risk to generate returns through the investments made from the aggregated premiums. Hence there is a transfer of risk across the insurance sector value chain. Insurance companies generate profits from how well they can manage their risks which involves a comprehensive due diligence process of risk assessment of the insured clients when pricing premiums for them and during their investment process. With ESG issues becoming critical for businesses, it is imperative that these be integrated in the insurance sector as well. The ESG risks that businesses face will be transferred to the insurance companies when an insurance is sold in the market. A useful framework to be considered in this case is the UNEP-FI Principles for Sustainable Insurance (PSI).

Insured losses from weather related events over the last decade averaged over US$63b annually.

Source: https://www.swissre.com/dam/

It suggests that the risk and opportunities offered by the ESG factors must be considered by the insurance companies when managing their own businesses. The underlying principle for PSI is that as risk managers, risk carriers and investors, insurers can play a pivotal role in encouraging sustainable development.

As climate-change related events become more frequent and businesses are adversely impacted by such occurrences, the risks will be borne by the insurance providers who will have to pay out huge sums of money as claims to these businesses. If the insurance companies do not mitigate such risks by considering ESG factors during the insurance underwriting process. While ESG metrics to be considered during the insurers’ investment decisions are already established, the process of integrating it in the underwriting part is still immature. Some ESG factors to be considered in impact underwriting include the attitude and behavior: (i) on environmental issues such as resource depletion, climate change, waste and pollution; (ii) regarding people, workers and local communities, including health and safety issues; and (iii) referring to corporate policies and governance, including tax strategy, corruption, structure and remuneration.

At the same time, insurance companies are one of the major institutional investors owing to the large sums of accumulated premiums at their disposal. Such investors operating within long investment horizons can play a major role in financing the move towards a low-carbon economy. Factoring such issues in their strategic decision-making process, will not only help insurance companies to stay competitive in the market but also help them to satisfy investors’ increasing demand for sustainable products.

https://www.unepfi.org/psi/the-principles/
Challenges in ESG integration
ESG has become a buzzword across industries in the recent years. In the financial services sector as well, ESG investing has off-late been the hearsay as highlighted by a 34% surge in sustainable investments to over US$30t since 2016 as per Global Sustainable Investment Alliance (GSIA). This has spurred a trend of ESG integration in the strategy/operations of different organizations in the financial services sector. ESG integration is grappling with certain challenges.

There is a lack of standardization in the ESG marketplace. ESG being a new concept lacks a conclusive methodology to define its different concepts. There is a variation in the interpretation and analysis of ESG across different communities and jurisdictions. This has led to an increase in greenwashing in certain cases where asset managers label the product as ESG but do not put in adequate ESG judgements while making investments. Some of them have been under spotlight in the past year for having included certain gun companies in their ESG index funds despite the prospectus stating it to be an excluded industry. The lack of a standard global regulation around ESG disclosures has given a leeway to companies to decide what factors are material to their business and what information should be disclosed to the investors. The lack of consistent, comparable and material information hinders the ability of investors to efficiently allocate capital.

For example, there is a lack of scenario modelling to gauge the climate related risks in the financial sector space. Assessing these risks requires not only sustainability expertise but capability across risk management, credit risk, accounting and finance.

The increasing flow of capital in ESG investing has witnessed a burgeoning number of data providers in the marketplace. These data providers play an important part in the investment process by gathering and assessing information about a companies’ ESG practices and then rating them. The development of rating systems has boosted the ESG investing landscape as the investors and ESG managers make use of such ratings in their decision-making process. Despite the benefit, the investors and asset managers face a challenge in understanding the limitations of the data provided as well as the dilemma of relying on any particular rating system. Each rating system involves its own sourcing, research and scoring methodology which results in a single company being rated differently across data released by different ESG rating agencies. This poses a key challenge as there is lack of transparency in the data collection and scoring mechanism process.

Many rating agencies, however, are now trying to take the investor community on board in developing an ESG rating system that is guided by:

- Bringing in greater transparency to materiality considerations which form the backbone of a rating system
- Developing a rating system that is based on a framework supported by many investors
- Promote market infrastructure that both integrates stewardship into ESG scoring and incentivizes greater corporate disclosure of investor relevant ESG information

### Risk, returns and resilience: Integrating ESG in the financial sector

**Banking**
- Liability risk exposure as a result of corporate mismanagement of climate risks or environmental impacts of operations
- Increased financial risk due to transition costs
- Impact on financial returns in a variety of ways, including critical infrastructure damage
- Financial risk to banks due to insurance companies excluding claims relating to environmental damage
- Investment portfolio exposure
- Investor and public confidence

**Insurance**
- Weather related losses has tripled since 1980. Related costs have jumped from US$10b to US$50b a year increasing claims
- Liability risk exposure as a result of corporate mismanagement of climate risks or environmental impacts of operations, resulting in more claims
- Increased financial risk due to transition costs
- Limited reporting capabilities on climate change impact due to lack of transparency

**Asset Management**
- Legislation will increase following of Paris Accords, leading to higher regulatory risk
- Liability risk exposure as a result of corporate mismanagement of climate risks or environmental impacts of operations
- Financial risk due to investors demanding increased disclosure on their exposure to stranded assets
- Increased financial risk due to transition costs
- Investment portfolio exposure
- Investor and public confidence
The World Economic Forum (WEF), through its International Business Council (IBC), on 22 September 2020, released a report “Measuring Stakeholder Capitalism: Towards Common Metrics and Consistent Reporting of Sustainable Value Creation” with an objective of identifying a set of universal, material ESG metric which companies can use in preparing their mainstream annual reports. The report is based on project by WEF-IBC is a collaboration with Bank of America, EY and other Big Four firms. The project focused on identifying a shared set of ESG metrics that allow businesses to better demonstrate their contributions toward long-term value creation and the UN Sustainable Development Goals (SDGs). The metrics are divided among four overarching pillars of “People”, “Planet”, “Prosperity” and “Principles of Governance”, where EY contributed to the “Prosperity” pillar.

The metrics consist of 21 core metrics, or Stakeholder Capitalism Metrics (more critically important and established metrics) and 34 expanded metrics (extended to entity’s entire value-chain scope).

**Principles of governance**
Company’s purpose, governance and accountability. This pillar includes metrics in relation to how companies set purpose, are governed responsibly and manage risks.

**Planet**
Company’s role in protecting the planet to support the needs of current and future generations. Metrics include GHG emissions, TCFD implementation, land protection and water consumption and withdrawal in water stressed areas.

**People**
Company’s responsibility to its people in creating diverse, safe and inclusive workplaces. Metrics include diversity and inclusion, pay equality, safety, training and human rights.

**Prosperity**
Company’s role in furthering economic, technological and social progress for its communities. Metrics include employment, taxes paid and research and development expenditure.

Risk, returns and resilience: Integrating ESG in the financial sector
EY’s value proposition
As businesses look to define and adapt to ESG taking center stage, it is essential for the financial sector to move from building a corporate strategy which is sustainable. The financial sector should consider employing ESG factors by:

1. Enhancing ESG strategy and methodologies in investment decision-making
2. ESG factors and enhanced climate risk methods within the investment due diligence process, risk-management processes, stress test and portfolio impact assessment
3. Staying ahead of the regulatory tide and prepare for upcoming deadlines – while critical technical standards and specifications are still under discussion and not yet finalized
4. Instilling discipline into nonfinancial reporting processes and controls to build confidence and trust

EY teams globally are already working with financial services sector to help development and implementation of ESG strategy and methodology, climate risk assessment, impact assessment of investments and ESG disclosures. EY ESG solutions set a trajectory for resilient financial institutions.

**Strategy, risk & resilience**

- **How do ESG factors influence investment decision-making?**
  - Embed ESG across the organization through governance structures and policies which demonstrate ESG commitment
  - Advice on sustainability strategy, including policy support
  - ESG materiality assessment and benchmarking
  - Climate strategy advice
  - Embedding ESG in Enterprise Risk Management
  - Building a business case for long-term value (LTV) creation

**Implementation**

- **Are your business operations resilient enough to respond to the complex ESG risks?**
  - Develop processes that enable and support effective ESG implementation
  - ESG maturity assessment for investe/portfolio companies
  - ESG framework and policy support for investee companies
  - Pre-investment ESG due diligence, including in relation to climate change
  - ESG integration and performance measurement, including KPI definition
  - LTV-related services

**Reporting and assurance**

- **How will you know that your ESG strategy is delivering the desired outcomes?**
  - Develop reporting metrics and framework in line international practices and regulations
  - ESG reporting and ratings - alignment with industry requirements/guidelines (e.g. ESG Ratings such as DJSI, MSCI, FTSE4Good and ISS-Oekom; and frameworks such as GRI, IR, TCFD and PRI
  - ESG Impact of portfolio/ banks
  - Assurance for ESG reporting
Financial Institutions are the growth engine of the economy, providing the essential capital to other sectors of the economy. This makes financial sector an integral part of the ESG agenda. The diverse sectoral exposure, through capital allocation or lending, is also responsible for various environmental and social impacts. India too, following the global trends, has witnessed a traction in ESG related decision-making and product offerings such as, ESG-focused mutual funds. India’s capital markets regulator SEBI has also recommended that asset managers engage with portfolio companies on ESG risk management and performance. EY’s Climate Change and Sustainability Services (CCaSS) team, works closely with such asset managers as well as portfolio companies to improve their ESG performance. For portfolio companies from various sectors, EY has developed a three-layered framework, “Sustainable by Design”, that guides organizations in the design, development, implementation and communication of sustainability initiatives.

Building a resilient financial sector for now, next and beyond
As the financial sector envisions the now, next and beyond in the face of an uncertain economic environment, it is imperative for the sector to develop resilience and response to risk management.

Traditionally overlooked among the E-S-G risks trinity of investment decision-making, social aspects of businesses such as policies and resources to effectively minimize any possible spike in the COVID-19 trajectory is of the immediate concern in the now. The investor focus has shifted to evaluating aspects such as employee health and safety, employee welfare and benefits, supporting public health efforts, and operational continuity for investment-decisions.

Major issues faced by wealth and asset managers during the pandemic were fund liquidity risks and asset valuation difficulties. In the next of the COVID-19 crisis, as organizations reframe their business models and strategies to make the most of the megatrends, investors could factor in developing an ESG strategy and methodologies in investment decision-making. EY believes that going forward, both investors and regulators will demand enhanced climate risk and stress tests, which include ESG factors related to liquidity and valuations in order to navigate through potential tail risk events and improve overall returns. Additionally, the upcoming climate risk regulations are likely to require the enhanced disclosure of utilized models and scenarios.

For disclosures 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 is 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.

Beyond the COVID-19 crisis, new opportunities may arise for various impact funds on furthering sustainable development agenda and building a resilient economy, such as health and wellbeing, access to digital infrastructure, access to education and affordable housing. Additional stakeholder concern for greenwashing and SDG-washing would lead to impact assessment of such investments and considering long term value created by businesses, along with financial returns.

Prior to COVID-19, ESG factors were often considered a choice between positive impact returns and investing goals. During the pandemic, ESG funds have actually outperformed classic indices, and ESG factors emerged as major indicators of resilience in this crisis. The crisis has offered the opportunity for the financial sector to manage risks, improve returns and build a resilient economy for crisis-resilient long-term value creation.

The COVID-19 pandemic has acted as a wake-up call for businesses, highlighting the need for inclusion of ESG factors in their corporate strategy for managing risks and returns, while ensuring that we build resilient systems for long-term value creation.
# Appendix

## References to the key global regulations

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<th>Disclosure</th>
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</thead>
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<td>The Taxonomy Regulation</td>
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<tr>
<td>India</td>
<td>Companies Bill 2013</td>
<td><a href="http://www.mca.gov.in/MinistryV2/companiesact2013.html">http://www.mca.gov.in/MinistryV2/companiesact2013.html</a></td>
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<tr>
<td>New Zealand</td>
<td>TCFD-based reporting to become mandatory</td>
<td><a href="https://www.mfe.govt.nz/consultations/climate-related-financial-disclosures">https://www.mfe.govt.nz/consultations/climate-related-financial-disclosures</a></td>
</tr>
<tr>
<td>Singapore</td>
<td>Listing Rule</td>
<td><a href="https://www.sgx.com/regulation/sustainability-reporting">https://www.sgx.com/regulation/sustainability-reporting</a></td>
</tr>
</tbody>
</table>
Glossary

**Black Swan event:** A black swan is an unpredictable event that is beyond what is normally expected of a situation and has potentially severe consequences. Black swan events are characterized by their extreme rarity, severe impact, and the widespread insistence they were obvious in hindsight.

**Business as usual:** As per IPC C, under the Business-as-Usual (Scenario A) emissions of greenhouse gases, a rate of increase of global-mean temperature during the next century of about 0.3°C per decade (with an uncertainty range of 0.2°C to 0.5°C per decade); this is greater than that seen over the past 10,000 years. This will result in a likely increase in global-mean temperature of about 1°C above the present value by 2025 and 3°C before the end of the next century.

**GRI:** The Global Reporting Initiative is an international independent standards organization that helps businesses, governments and other organizations understand and communicate their impacts on issues such as climate change, human rights and corruption.

**IASB:** The International Accounting Standards Board is an independent accounting standard setter, a London-based organization which seeks out to set and enforce standards for accounting procedures. At present, more than 100 countries require or permit companies to comply with IASB standards.

**IOSCO:** The International Organization of Securities Commissions is an association of organizations that regulate the world’s securities and futures markets.

**SASB:** The Sustainability Accounting Standards Board is a non-profit organization, founded in 2011 by Jean Rogers to develop sustainability accounting standards.

**REIT and InvIT:** innovative vehicles that enable developers to monetize their revenue-generating real estate/infrastructure assets and release capital for funding new infrastructure/real estate projects. REITs/InvITs allow investors to invest in these assets without owning them. Since the units of the trusts are listed on the stock exchanges, they also provide liquidity to investors in an otherwise largely illiquid asset class.

**TCFD:** The Task Force on Climate-Related Financial Disclosures was created in 2015 by the Financial Stability Board (FSB) to develop consistent climate-related financial risk disclosures for use by companies, banks, and investors in providing information to stakeholders. Increasing the amount of reliable information on financial institutions’ exposure to climate-related risks and opportunities will strengthen the stability of the financial system, contribute to greater understanding of climate risks and facilitate financing the transition to a more stable and sustainable economy.

**UNCTAD:** The United Nations Conference on Trade and Development was established in 1964 as a permanent intergovernmental body. UNCTAD is the part of the United Nations Secretariat dealing with trade, investment, and development issues.
# Acronyms

<table>
<thead>
<tr>
<th>Acronym</th>
<th>Full Form</th>
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<tbody>
<tr>
<td>AUM</td>
<td>Assets Under Management</td>
</tr>
<tr>
<td>CDP</td>
<td>Carbon Disclosure Project</td>
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<tr>
<td>DJSI</td>
<td>Dow Jones Sustainability Indices</td>
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<tr>
<td>EPIC</td>
<td>Embankment Project for Inclusive Capitalism</td>
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<tr>
<td>ESG</td>
<td>Environmental, Social and Governance</td>
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<tr>
<td>ETF</td>
<td>Exchange Traded Fund</td>
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<tr>
<td>EU</td>
<td>European Union</td>
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<tr>
<td>GHG</td>
<td>Greenhouse gas</td>
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<tr>
<td>GRI</td>
<td>Global Reporting Initiative</td>
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<tr>
<td>GSIA</td>
<td>Global Sustainable Investment Alliance</td>
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<tr>
<td>IASB</td>
<td>International Accounting Standards Board</td>
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<tr>
<td>ICGN</td>
<td>International Corporate Governance Network</td>
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<td>IFAC</td>
<td>International Federation of Accountants</td>
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<tr>
<td>InvIT</td>
<td>Infrastructure Investment Trusts</td>
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<tr>
<td>IOSCO</td>
<td>International Organization of Securities Commissions</td>
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<tr>
<td>LMIC</td>
<td>Low and Middle Income Countries</td>
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<tr>
<td>NGO</td>
<td>Non-Governmental Organization</td>
</tr>
<tr>
<td>OECD</td>
<td>Organization for Economic Co-operation and Development</td>
</tr>
<tr>
<td>REIT</td>
<td>Real Estate Investment Trusts</td>
</tr>
<tr>
<td>SASB</td>
<td>Sustainability Accounting Standards Board</td>
</tr>
<tr>
<td>SDG</td>
<td>Sustainable Development Goals</td>
</tr>
<tr>
<td>TCFD</td>
<td>Task Force on Climate-related Financial Disclosures</td>
</tr>
<tr>
<td>UNCTAD</td>
<td>United Nations Conference on trade and Development</td>
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<tr>
<td>UNEP-FI</td>
<td>United Nations Environment Program- Finance Initiative</td>
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<tr>
<td>UN PRI</td>
<td>United Nations’ Principles for Responsible Investment</td>
</tr>
<tr>
<td>UN PSI</td>
<td>United Nations’ Principles for Sustainable Insurance</td>
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<tr>
<td>WEF</td>
<td>World Economic Forum</td>
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</tbody>
</table>
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