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Adapting to a changing climate: an Introduction to ESG

What is ESG

ESG stands for environmental, social and governance, a term used both in specific legal and regulatory contexts and more generally to capture a wide range of characteristics of an organisation or business. In the financial sector, ESG is often used as a general umbrella term to refer to non-financial factors against which investors may assess the behaviour of an entity they are considering investing in, as part of their analysis for identifying material risk and growth opportunities.

ESG is commonly referred to alongside the concepts of corporate governance and corporate social responsibility. Collectively, these terms refer to the decisions and behaviours of an organisation in relation to social responsibility, in areas such as ethics, the environment, diversity, human rights, integrity, labour chain, climate change, philanthropy, accountability, sustainability, values, community, transparency and fair trade over the long term.

Why is ESG important?

The increasing importance of ESG issues and policies can be attributed to a convergence of many overlapping factors, including:

1. The rise in public concern for environment and social equity, which is reflected by an increasing desire from the public that organisations and investments therein are ethical.
2. A better understanding by investors of the risks posed to the underlying investments as a result of ESG issues. For example, direct risks from climate change related flooding or droughts, or indirect risks such as increasing/decreasing demand for products by consumers based on the ESG profile of the product and/or the supplier/producer.
3. A hugely increased legal and regulatory burden on organisations which presents significant operational and logistical challenges needing to be addressed at all levels of the organisation.
4. The simple fact that many consumers, counter-parties and investors are now self-motivated to "do the right thing".

Investors (as well as the general public) increasingly expect ESG related disclosures to include not only the compliance of an organisation with current regulations but also an organisation's cultural commitment to have a positive impact on the key ESG factors associated with its activities, irrespective of whether or not that organisation is heavily regulated. Clearly, many investors will consider ESG issues as a matter of principle and take decisions based on ethical considerations.

However, having comparatively higher ESG standards can itself have financial benefits for an organisation, such as improvements to cost base, reputation, goodwill, eventual value and sale-ability of the investment. Conversely, poor or failing ESG management can lead to significant share price volatility. These financial considerations cannot be overstated and may ultimately be greater drivers for change than purely ethical considerations. For example, in July 2020 Boohoo (the online fashion retailer) saw its share value fall by 50% when supply chain concerns were identified including allegations about pay and working conditions at supply factories. More recently, in May 2021 a tweet by Elon Musk indicating that Tesla had suspended purchases of its vehicles using bitcoin due to its concerns over the "*rapidly increasing use of fossil fuels for bitcoin mining*" resulted in the value of bitcoin dropping dramatically within an hour of the tweet (although it has since recovered). Not only did the tweet impact on the financial value of bitcoin, it also increased the public's awareness of the environmental impact of cryptocurrencies, an area which the industry will have to address if it is to survive the climate change revolution.

How is ESG measured?

Broadly speaking:

- The environmental aspect of ESG measures an organisation's impact on the natural environment by looking at metrics such as an organisation's carbon footprint, its impact on biodiversity and its production of waste and pollution.
- The social aspect of ESG measures how an organisation treats the people it comes into contact with including employees, customers and the communities within which it operates.
- The governance aspect of ESG measures how an organisation operates in terms of audits, board diversity, internal controls, tax compliance and shareholder rights. These factors help investors and stakeholders to measure an organisation's performance and to ensure proper accountability.

However, the assessment of ESG policies and practices will depend on the particular sector and is a developing area. While it is not yet possible to set out an exhaustive list of ESG criteria on which a company's performance can be judged, many institutional investors have signed up to the United Nations Principles of Responsible Investment: (https://www.unpri.org/pri/what-are-the-principles-for-responsible-investment). These voluntary investment principles encourage positive actions for incorporating ESG issues into investment practice by signatories committing to:

1. Incorporate ESG issues into investment analysis and decision-making processes.
2. Be active owners and incorporate ESG issues into their ownership policies and practices.
3. Seek appropriate disclosure on ESG issues by the entities in which they invest.
4. Promote acceptance and implementation of the Principles within the investment industry.
5. Work together to enhance their effectiveness in implementing the Principles.
6. Each report on their activities and progress towards implementing the Principles.

A further useful reference point is the EU Taxonomy Regulation which is intended to create a classification system by providing companies, investors and policymakers with appropriate definitions for economic activities which can be considered environmentally sustainable. The process of refining those definitions is still ongoing and there are understandable differences of opinion across the various stakeholder groups across the Member States. However, once the defined terms are in use, it is likely that they will be used more widely or at least provide a useful point of reference and comparison.

More generally, evaluating ESG is not simply about checking for compliance with current regulations, but is increasingly about a cultural commitment within an organisation to have a reduced impact on the various ESG factors associated with an organisation's activities, irrespective of regulatory requirements. High scoring on ESG factors signals to stakeholders a more sustainable and resilient business with better prospects of thriving and surviving.

What is "greenwashing"?

According to the EU Taxonomy Regulation, greenwashing "refers to the practice of gaining an unfair competitive advantage by marketing a financial product as environmentally friendly, when in fact basic environmental standards have not been met." More generally, it could be described as conduct which conveys the false impression that a company or a product are more environmentally sound than is actually the case. "Greenwashing" claims are considered in more detail in our separate article on ESG and Litigation Risks.

What is the Paris Agreement?

Climate change is generally viewed as one of the most serious threats faced by modern society and a wide raft of international, regional and domestic legislation has been implemented to combat that threat. The most high profile and ambitious international treaty in relation to climate change issues is the Paris Agreement, which serves to heavily influence government policy and legislation. Its goal is to limit global warming to well below 2 degrees Celsius per annum (and ideally 1.5), compared to much higher pre-industrial levels. To achieve this long-term objective, the signatories aim to achieve a climate neutral world by the middle of the 21st Century. The Paris Agreement is a legally binding international treaty on climate change. It was adopted by 196 Parties (including by 55 countries which account for at least 55% of global greenhouse gas emissions) in Paris, on 12 December 2015 and came into force on 4 November 2016. For the first time, a binding agreement brought together all signatory nations into a common cause to undertake ambitious efforts to combat climate change and adapt to its effects. Governments are required to submit 5-year cycle plans for climate action known as nationally determined contributions ("**NDCs**"), setting out what actions they will take to reduce their Greenhouse Gas emissions in order to reach the goals of the Paris Agreement as well as to detail how they intend to build resilience/adapt to the impact of rising temperatures. The Paris Agreement also invites (but does not mandate) countries to formulate and submit long-term low greenhouse gas emission development strategies ("**LT-LEDS**").

On 12 December 2020, the UK Government communicated its ambitious new NDC under the Paris Agreement to the United Nations Framework Convention on Climate Change. The NDC commits the UK to reducing economy-wide greenhouse gas emissions by at least 68% by 2030, compared to 1990 levels. Along with the NDC, the UK published an Adaptation Communication and a Biennial Finance Communication which complements the NDC, and which details UK action across the mitigation, adaptation, and finance pillars of the Paris Agreement. The 68% target by the UK Government is among the highest in the world and commits the UK to cutting emissions at the fastest rate of any major economy so far. The UK's previous NDC target for 2030 was 53%.

ESG reporting and disclosures: what do organisations need to do now to comply, and what will they need to report and disclose in the near future?

UK Companies

ESG metrics and disclosures (both voluntary and mandatory) are an increasing focus for organisations as they respond to a wave of scrutiny by stakeholders including shareholders, lenders, other investors, regulators, employees, customers and the public. ESG disclosures are expected to comply with mandatory and voluntary reporting requirements and be credible, verifiable and comparable, allowing stakeholders to make decisions that matter to them. However, there is no generally accepted global ESG reporting framework, and as a result a number of private sector reporting frameworks have been developed by non-governmental organisations for these purposes. A number of institutions, such as the Sustainability Accounting Standards Board ("**SASB**"), the Global Reporting Initiative ("**GRI**"), and the Task Force on Climate-related Financial Disclosures ("**TCFD**") have worked to form standards and define materiality to facilitate incorporation of these factors into the investment process. These standards allow companies to self-report non-financial information on a voluntary basis, often in response to pressure from customers and investors.

ESG Standards

The SASB provides a set of 77 industry-specific sustainability accounting standards covering material ESG factors for each such industry.

The GRI Standards require extensive corporate disclosure against a comprehensive index of ESG reporting metrics.

The TFCD report sets out what information companies should disclose to enable investors, lenders and insurance underwriters to understand how organisations approach and manage climate-related financial risk. The recommendations include 11 standard climate-related disclosures in four areas (governance, strategy, risk management, metrics and targets). These primarily require narrative disclosures, explaining how a company has incorporated the consideration of climate-related risks into various aspects of its governance, so that investors can assess how prepared a company is for the shift to a low carbon economy, and require companies to focus on the resilience of an organisation's strategy, taking into consideration different climate-related scenarios, including a 2° Celsius or lower scenario.

Of these, the TFCD recommendations are emerging as the lead framework for climate change reporting, and were officially endorsed by the UK Government in July 2019 when it published its Green Finance Strategy, which stated that it expected all UK listed issuers and large asset owners to provide disclosures in line with the TCFD recommendations by 2022, and established a UK joint taskforce to examine the most effective way to achieve this objective.

Further on 9 November 2020, the Treasury published an Interim Report and Roadmap Towards Mandatory Climate Related Disclosures, which confirmed that the Government would introduce mandatory TCFD climate disclosures by 2025, with a significant portion of mandatory requirements in place by 2023. The Report stated (amongst other things) that:

- For accounting periods beginning on or after 1 January 2021 commercial companies with a premium listing will be mandated, within Listing Rule 9.8, to state in their annual reports whether they have disclosed in line with the TCFD's recommendations, or explain why disclosures have not been made.

- In March 2021, the Department for Business, Energy and Industrial Strategy issued a public consultation on new obligations requiring publicly quoted companies, large private companies and LLPs registered in the UK to make TCFD disclosures in their annual reports, with the necessary regulations anticipated to take effect in mid to late-2021.
- In June 2021 the FCA published a consultation paper on extending its rules for climate-related disclosures to standard listed issuers.
- Separate consultations will be undertaken in relation to occupational pension schemes, asset managers (along with open and closed ended investment companies), life insurers and pensions providers.

Many listed and large companies in the UK are already subject to a number of mandatory environmental reporting requirements, including under the Streamlined Energy and Carbon Reporting regime, which requires the inclusion by companies of quantitative disclosures regarding greenhouse gas emissions and energy use in annual reports.

On 10 November 2020, the Financial Reporting Council ("**FRC**") published a statement recommending that in the next reporting cycle UK public interest entities should (on a voluntary basis) report not only against the TCFD recommendations but, in addition, on the basis of the relevant SASB standards for their sectors. The statement indicates that the FRC will be considering how companies can report under both the TCFD and SASB to meet the needs of investors, and highlighting the longer term need for a corporate reporting framework which meets the needs of stakeholders more generally, not just investors.

For many companies, the EU regime will also be relevant, for example if they fall within the scope of the Non-Financial Reporting Directive (which will be amended by the proposed EU Corporate Sustainability Reporting Directive).

Asset Management and Financial Services

ESG is an increasingly important issue for investors and, therefore, for those managing their assets. The impact applies both to investment management decisions and client expectations of the organisation itself. By their nature, asset managers will be concerned with the financial performance of assets and their strategies will necessarily take into account ESG characteristics. However, of equal importance will be the expectations of their clients and the obligations on managers and other service providers. These expectations and obligations may arise from regulatory obligations, contractual commitments in relation to a particular mandate or from disclosures made to the particular client or the world at large. For many this will involve cross-border activity, particularly in the EU.

There have been a wide range of recent industry, legal and regulatory measures which apply to disclosure and reporting in the financial services and asset management sectors. These measures have principally emanated from the EU and include:

- EU Sustainable Finance Action Plan
- EU Taxonomy Regulation
- EU Sustainable Finance Disclosure Regulation
- EU Low-Carbon Benchmarks Regulation
- EU Non-Financial Reporting Directive[1]
- EU Shareholder Rights Directive

Although the EU regime was not fully adopted into UK law during the Brexit transition period, the UK government has made a minimum commitment of matching the key objectives of the EU Sustainable Finance Action Plan. In practice, the UK regime is likely to follow developments in the EU very closely and most participants in the asset management sector will have to comply with the EU rules in any event.

From 1 January 2020, an updated version of the Stewardship Code (a voluntary set of standards issued by the FRC for asset managers, asset owners, and service providers to follow - the "**Code**") has been in effect. The updated Code introduces new principles for different signatory groups as well as introducing new thematic issues centred on ESG issues. It recognises that environmental, particularly climate change, and social factors, in addition to governance, have become material issues for investors to consider when making investment decisions and undertaking stewardship, and that asset owners and asset managers play an important role as guardians of market integrity and in working to minimise systemic risks as well as being stewards of the investments in their portfolios. Whilst the Code is voluntary, since December 2010, FCA authorised asset managers have been required (under the FCA's Conduct of Business Rules) to disclose whether, and if so how, they comply with it. Many asset owners and service providers have voluntarily become signatories to the Code, in part because voluntary compliance is encouraged by third parties.

[1] To be amended by the proposed Corporate Sustainability Reporting Directive.

Directors' Duties in relation to ESG - section 172 of the Companies Act 2006 ("CA 2006")

Under section 172 of the CA 2006, directors have a duty to promote the success of the company, which is defined as meaning that a company director must act in a way they consider, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole.

In fulfilling their duties directors must have regard to a non-exhaustive list of factors, including: the likely consequences of any decision in the long term; the need to foster the company's business relationships with suppliers, customers and others; and the impact of the company's operations on the community and the environment. Overall, this duty has become known as the concept of "enlightened shareholder value". It is clear that in considering what is likely to promote the success of the company as a whole, that directors consider other stakeholder groups, such as employees, suppliers and customers as well as the likely consequences and long term impact of their decisions on the community and the environment.

For financial years beginning on or after 1 January 2019, "large" companies (as defined in the CA 2006) must include a separate "section 172(1) statement" in their strategic report, which describes how the directors have had regard to the matters set out in section 172(1)(a)-(f) CA 2006 when performing their duty under section 172. Unquoted companies must publish their section 172(1) statement on a website (maintained by or on behalf of the company).

A rising tide sinks all boats

As stated by the FRC, "*climate change is a defining issue of our time affecting us all. While for some companies the challenge may be further on the horizon, climate change must be integrated into decision making now if it is to be tackled in an orderly way*".

Members of the public, investors, directors, regulators and the government expect organisations to commit to positive ESG changes, and not simply to give lip service to ESG issues. Organisations will increasingly be held to account for any failings, no doubt under significant public scrutiny. ESG reporting and disclosures are likely to become more prescriptive, detailed and regulated, and this will result in significant differentiation between organisations that are perceived to be successful and those that are perceived to have failed. To put it simply, this is not a temporary issue and the obligations and related scrutiny will only increase over time. It is essential therefore that organisations take proactive steps to meet their obligations where possible and to act quickly when any failings are identified.

In our separate article on "ESG and Litigation Risks", we consider the risks associated with failing to meet ESG expectations including some specific issues which have arisen to date, as well as the future of ESG litigation and the likely challenges and opportunities that will arise.

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