ESG disclosures for financial institutions: loose rules good for on-boarding not trust

Integrating ESG factors is a frontier theme for the finance industry. Progress varies widely between asset classes, investor types, and geographies. Shortcomings relating to ESG disclosures – including greenwashing – undermine market developments yet there is no consensus among investors and issuers on what ESG means, and awareness of ESG issues is uneven. Sceptics believe ESG is just the latest hot topic and will remain a niche market, while activists are pushing hard to make ESG integration mainstream. Expectations are rising on all fronts.

Banks, as confidence-sensitive businesses, must address ESG gaps in view of possible legal and reputational risks. Issues arising today related to greenwashing in the asset management industry will eventually expose banks to similar controversies. Scope considers that proactive ESG integration can provide a competitive edge to European banks if backed by rigorous disclosure and it will increase the scrutiny on ESG laggards.

Avoiding claims of greenwashing is one of the main ESG disclosure challenges for banks. Greenwashing stems from the absence of proper disclosure standards and institutional frameworks to authenticate disclosures, like auditable accounts. The practice leads to unsubstantiated or misleading claims about the environmental performance of a company or a product. It creates suspicion about the reality and credibility of market participants' efforts and initiatives to green the financial system.

The state of play across Europe is characterised by weak reporting frameworks. By design, the initial standards aimed to raise awareness and improve integration of ESG factors. However, rapidly rising stakeholder expectations have exposed their weaknesses. For banks, the time has come to move to the next level.

ESG disclosure risks becoming a source of product liability for banks. This is another good reason to consider ESG integration as a very relevant credit issue. More sophisticated frameworks will introduce more rigid requirements. Furthermore, fines related to misleading disclosures, product mis-labelling, and consumer protection may come on top of reputational damage.

The need and pressure for higher quality ESG disclosure standards are increasing but there is still some way to go before widely accepted solutions are implemented. Hence, the risk of greenwashing is here to stay for the time being. On a positive note, the debate on proper ESG disclosures is shifting from its initial focus – lack of disclosure – to the more sophisticated issue of quality of disclosure.

This report highlights how this trend is taking shape for European banks, from the current loose framework set by the non-financial reporting directive (NFRD) to the more stringent, albeit not yet fully articulated Corporate Sustainability Reporting Directive (CSRD). The mixed application of the United Nations Sustainable Development Goals (UN SDGs) as an ESG reporting tool by banks illustrates the mounting competitive threat for banks, testing their ability to adopt more convincing and demanding frameworks like the UN Principles for Responsible Banking.

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The current EU ESG disclosures framework a loose but progressive step

About 11,700 large companies and groups fall under the scope of the NFRD, which will give way to the CSRD. The NFRD is designed to foster awareness of ESG issues and acceptance of the need to improve disclosures. The Directive amended the existing accounting directive, requiring large companies, including banks, to disclose how they approach a set of broad ESG-related issues in terms of policies, risks and key performance indicators.

The NFRD is not prescriptive: it does not articulate in a precise manner how reporting must be carried out. The open-ended nature of the NFRD is well illustrated by the decision to complement the Directive with non-binding general guidelines rather than technical standards. In the Appendix, we outline the open-ended nature of the NFRD and how non-exhaustive lists of alternative frameworks are referenced to facilitate compliance with the formal reporting requirement. Listing those inspiring frameworks is intended to facilitate the emergence of best practices and the adoption of gradually refined frameworks.

A faster move towards a more prescriptive framework is held back by the novelty of the topic for many market participants, by the absence of a common understanding of each factor, and the ambition to encompass them all in a single framework.

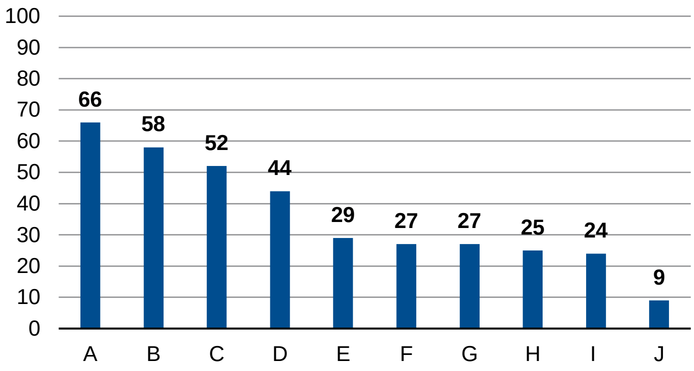
Moving from 'no disclosures' to 'all sorts of disclosures' facilitates the emergence of standards

Given this preferred approach, it should come as no surprise that the NFRD achieved mixed results in terms of market convergence. These limitations, and other hindering challenges are well documented, thanks, for instance, to comprehensive studies published by the European Commission itself[1]. We see efforts to highlight the weaknesses of the current framework as a deliberate and positive move to accelerate the adoption of a more sophisticated framework.

A survey conducted as part of a CEPS study illustrates this heterogeneity: companies use different reporting frameworks, rely on each of them to a varying extent, and they tend to combine them to produce their own reporting documents (Figure 1).

Figure 1: Reporting framework used for non-financial statements

Frequency of usage (%)



Source: CESP study, p.108

Legend

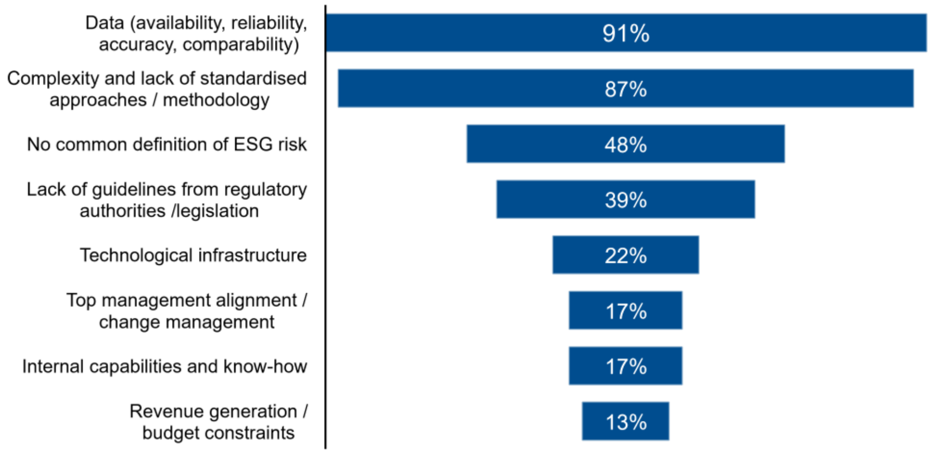
A: Global Reporting Standards
B: UN Global Compact
C: European Commission Guidelines on nonfinancial reporting
D: CDP (Climate Disclosure Project)
E: European Guidelines on climate-related reporting
F: OECD Guidelines for Multinational Enterprises
G: International Labour Organization Tripartite Declaration of Principles concerning multinational enterprises
H: UN Guiding Principles on Business and Human Rights.
I: Task Force on Climate-related Financial Disclosures
J: Eco-Management and Audit Scheme

[1] Studies available at https://ec.europa.eu:
- CEPS study published in November 2020 by the European Commission: *Study on the Non-Financial Reporting Directive*.
- BlackRock study published in August 2021 by the European Commission: *Development of Tools and Mechanisms for the Integration of ESG Factors into the EU Banking Prudential Framework and into Banks' Business Strategies and Investment Policies* (final study, May 2021)

Another key limitation of the NFRD regime relates to data quality. The Directive imposes responsibilities on member States to ensure that adequate and effective means exist to guarantee disclosure of non-financial information, but there is no obligation for the disclosures to be audited. The only check to be performed by auditors is on the existence of a non-financial reporting statement, not on its content.

Next to data quality and heterogeneity of approaches, the extensive BlackRock study also highlights the lack of a commonly understood definition of ESG risk factors and the heterogeneity of approaches followed to identify ESG risks, from an integrated governance standpoint, a strategic perspective, or the selection of indicators (Figure 2).

Figure 2: banks' most common challenges to report on ESG



Ranking of top 3 challenges. Question: What are biggest challenges your organization faces while defining, identifying, assessing and managing ESG risks? Please rank the top three factors, with 1 being the most relevant.
Source: BlackRock study, p.59

An inherently loose ESG reporting framework exposes banks to greenwashing, but also provides ground for best-in-class differentiation

By transferring the nitty-gritty task of documenting ESG issues to companies, the NFRD framework inherently exposes banks to the risk of greenwashing. In the absence of clear standards or binding reference frameworks ESG compliance is hard to assess. Any definition of ESG can be used to challenge the degree of ESG compliance relative to market practice. This is even more acute in an environment where impact investing is gaining traction.

Scrutiny of the quality of ESG disclosures may arise in relation to ESG reporting. This is of interest to investors but also the marketing of financial products under an ESG label sold to consumers. With such a loose regime, companies need to set proper disclaimers to protect themselves against claims that they are over-selling and under-delivering on ESG products. Improving investor and consumer protection has been a constant concern for market authorities and a clearly stated ambition of the NFRD.

Advanced ESG integration provides a competitive edge

On a positive note, this flexible framework also creates opportunities for banks to adopt best-in-class practices and differentiate themselves from competitors. Some banks are more advanced and better equipped than others to grasp ESG risks and opportunities in the markets in which they operate. Given the current state of play, we believe a well-managed integration of ESG factors can be a source of competitive advantage and a tool to avoid being exposed to controversies.

Ambitious EU disclosures framework is leaning toward mandatory sustainability reporting standards by 2022

In April 2021, The European Commission adopted a proposal to amend the NFRD and introduce the Corporate Sustainability Reporting Directive (CSRD). In our view, the main benefit of the CSRD is to outline a clear roadmap to determine a more detailed and prescriptive framework. The proposal includes the following improvements:

- An extension of the **scope** of the reporting requirements to additional companies
- A requirement to perform an assurance check of sustainability reporting
- Specifying in more detail of the information that companies should report and requiring them to report in line with **mandatory EU sustainability reporting standards.**

Under this proposal, the Commission is due to adopt a first set of reporting standards by 31 October 2022 by means of delegated acts. The timeline appears very ambitious, although the clear intention to leverage existing standard-setting initiatives that have progressed since implementation of the NFRD should help. Progress made in EU laws to establish a coherent ecosystem on sustainability issues is notable.

The proposed reporting framework on environmental issues, for instance, is aligned with the EU Taxonomy (Box A). One of the objectives of the CSRD is to facilitate convergence between the various international, EU and national frameworks. In the meantime, the disclosure gap will remain. The risk of greenwashing will continue if technical standards appear to be just another tool to ease convergence i.e. prioritising process over content.

Box A: ESG disclosure items selected for inclusion in the proposed Corporate Sustainability Reporting Directive

ENVIRONMENT	• Climate change mitigation • Climate change adaptation • Water and marine resources • Resource use and circular economy • Pollution • Biodiversity and ecosystems
SOCIAL	• Equal opportunities for all, including gender equality and equal pay for equal work, training and skills development, and employment and inclusion of people with disabilities • Working conditions, including secure and adaptable employment, wages, social dialogue, collective bargaining and the involvement of workers, work-life balance, and a healthy, safe and well adapted work environment • Respect for the human rights, fundamental freedoms, democratic principles and standards established in the International Bill of Human Rights and other core UN human rights conventions, the International Labour Organization's Declaration on Fundamental Principles and Rights at Work and the ILO fundamental conventions and the Charter of Fundamental Rights of the European Union.
GOVERNANCE	• The role of the [company]'s administrative, management and supervisory bodies, including with regard to sustainability matters, and their composition • Business ethics and corporate culture, including anti-corruption and anti-bribery • Political engagements of the [company], including its lobbying activities • The management and quality of relationships with business partners, including payment practices • The [company]'s internal control and risk management systems, including in relation to the [company]'s reporting process

Source: CSRD

Reporting under the UN SDG framework: how competitive pressure is arising from the adoption of more robust standards

The move from broad generic frameworks to more demanding and prescriptive frameworks is a general trend in ESG integration. This trend is testing banks' ability to evidence in a convincing manner their efforts to align with stakeholder demands. Avoiding these initiatives without providing a reason or a timeframe questions banks' ability to measure and manage ESG related risks.

We believe heterogenous usage by European banks of the UN SDG framework of 17 goals illustrates this issue well.

SDGs are not legally binding. By design, the goals are very generic and often interconnected (Figure 3). As such, they have emerged as a widely-used tool for banks to communicate ESG-related information and their contribution to SDG alignment. The success of the framework as a communication tool lies in its simplicity and global acceptance. The framework is also referenced in the 2017 EC general guidelines (see Appendix) while the CSRD proposal intends to facilitate transition towards these goals.

Figure 3: The 17 UN Sustainable Development Goals

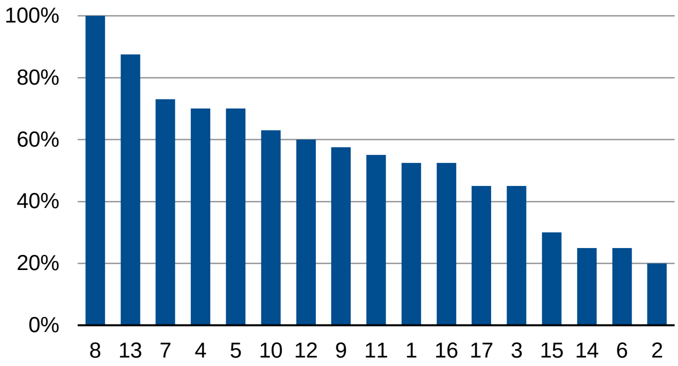
Source: www.un.org/susatinabledevelopment/

The SDG framework is widely used in banks' reporting documents but it is only one among several frameworks. Conclusions cannot be drawn from a review of reporting practices using this framework alone. But the wide array of practices may point to different levels of awareness and sophistication among banks.

In our view, best practices include a clear definition of strategic priorities demonstrated by the ranking of a limited number of goals for which there is a set of documented material actions performed by the bank.

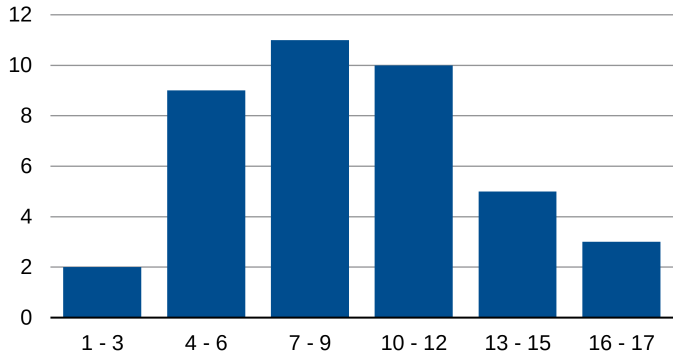
A review of a sample of 40 large European banks using annual reports or dedicated ESG disclosures illustrates the current state of play and a degree of convergence towards a small number of goals. The five most common goals are: goal 8 *Decent Work and Economic Growth* (100%), goal 13 *Climate Action* (88%), goal 7 *Affordable and Clean Energy*, goal 5: gender equality (70%), goal 4: quality education (70%) (Figure 4). While most banks prioritise a limited number of goals, others have opted for an all-encompassing approach (Figure 5)

Figure 4: Frequency of SDG's selection



Source: banks. Scope Ratings

Figure 5: Indicative number of goals selected by banks



Source: banks, Scope Ratings

Like for other ESG frameworks, monitoring results and progress is key. The SDG framework centred on 17 goals proposes 169 sub-targets for which progress can be tracked using a grid of 231 indicators. Mention of these more prescriptive indicators is much less frequent. However, it is fair to say that this framework was not intended to monitor progress at company but at country level, using mainly macro indicators.

As an alternative, the United Nations Principles for Responsible Banking (UN PRI) is an SDG-linked initiative to improve banks' reporting on their individual contributions[2]. Launched by 30 founding banks in September 2019, it has now been signed by over 240 banks. It sets a three-step framework and a four-year timeframe for banks to report progress. The framework is again self-declaratory, which limits data comparability but allows for the benchmarking of best practices precisely because ambitions are set at individual bank level.

The six underlying principles are: alignment; impact and target setting; clients and customers; stakeholders; governance and culture, and transparency and accountability. Some banks have already been removed from the signatory list because of non-compliance with membership requirements.

Box B: what is required from UN Principles for Responsible Banking signatories

Signatory banks commit to taking three key steps:

1. Analyse their current impact on people and planet

2. Based on this analysis, set targets where they have the most significant impact, and implement them

3. Publicly report on progress

Eighteen months after signing, signatory banks must report on:

- *their impact,*
- *how they are implementing the Principles,*
- *the targets they have set,*
- *the progress they have made.*

Within four years, signatory banks must have met all these requirements.

[2] https://www.unepfi.org/banking/bankingprinciples/

Appendix

Excerpts from the NFRD highlighting its open-ended nature
The NFRD requires large public companies (with more than 500 employees) to integrate disclosures on a set of pre-identified non-financial matters: Large public companies '*shall include in the management report a non-financial statement containing information to the extent necessary for an understanding of the undertaking's development, performance, position and impact of its activity, relating to, as a minimum,* ***environmental, social and employee matters, respect for human rights, anti-corruption and bribery matters****.* The Directive specifies the information to be provided on those matters, including: *a) a brief description of the [company]'s business model; (b) a description of the* ***policies*** *pursued by the [company] in relation to those matters, including due diligence processes implemented; (c) the outcome of those policies; (e)* ***non-financial key performance indicators*** *relevant to the particular business.* The determination of the reference reporting framework is left open: *Member States shall provide that [companies] may rely on national, Union-based or international frameworks, and if they do so, [companies] shall specify which frameworks they have relied upon.* Mandate is given to the European Commission to further facilitate the adoption of reporting frameworks: *The Commission shall prepare* ***non-binding guidelines*** *on methodology for reporting non-financial information, including non-financial key performance indicators, general and sectoral, with a view to facilitating relevant, useful and comparable disclosure of non-financial information by [companies].*

Reporting frameworks explicitly referenced in the EU Non-Financial Reporting Directive (recital 9)	
Companies may rely on national frameworks, Union-based frameworks such as ▪ the Eco-Management and Audit Scheme (EMAS), **or international frameworks such as** ▪ the United Nations (UN) Global Compact, ▪ the Guiding Principles on Business and Human Rights implementing the UN 'Protect, Respect and Remedy' Framework,	▪ the Organisation for Economic Co-operation and Development (OECD) Guidelines for Multinational Enterprises, ▪ the International Organisation for Standardisation's ISO 26000, ▪ the International Labour Organisation's Tripartite Declaration of principles concerning multinational enterprises and social policy, ▪ the Global Reporting Initiative**,** or other recognised international frameworks.

Reporting frameworks explicitly referenced in introduction of the non-binding general guidelines:	
CDP (formerly the Carbon Disclosure Project) **- the Climate Disclosure Standards Board** **- the OECD Due Diligence Guidance for Responsible Supply Chains from Conflict-Affected and High-Risk areas, and the supplements to it** **- the Eco-Management and Audit Scheme (EMAS) and the related Sectoral Reference Documents** **- the European Federation of Financial Analysts Societies' KPIs for Environmental, Social, Governance (ESG), a Guideline for the Integration of ESG into Financial Analysis and Corporate Valuation** **- Global Reporting Initiative** **- Guidance for Responsible Agricultural Supply Chains of FAO-OECD** **- Guidance on the Strategic Report of the UK Financial Reporting Council** **- Guidelines for Multinational Enterprises of the Organisation for Economic Cooperation and Development** **- Guiding Principles Reporting Framework on Business and Human Rights**	- ISO 26000 of the International Organisation for Standardisation - the International Integrated Reporting Framework - Model Guidance on reporting ESG information to investors of the UN Sustainable Stock Exchanges Initiative - the Natural Capital Protocol; - Product and Organisation Environmental Footprint Guides; - the Sustainability Accounting Standards Board; - the Sustainability Code of the German Council for Sustainable Development; - the Tripartite Declaration of principles concerning multinational enterprises and social policy of the International Labour Organisation; - the United Nations (UN) Global Compact; - UN Sustainable Development Goals, Resolution of 25 September 2015 transforming our world: the 2030 Agenda for Sustainable Development; - UN Guiding Principles on Business and Human Rights implementing the UN 'Protect, Respect and Remedy' Framework.

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