Issue 6 Special Edition – ESG

Reporting Matters

Does your ESG stand up to scrutiny?

luminous

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Our current operating model for big business is unsustainable. It simply has to change, and the time is now. There is a sustainability revolution taking place and it's the largest investment movement we've ever seen.

A global shift is already transforming our economies and the companies that drive them. And it is changing how markets are behaving. Our current economic, social and governance models have to evolve and we must fundamentally rethink established norms. No country, sector, company or asset class will go untouched.

In this edition of Reporting Matters, we focus on some of the key developments on the ESG landscape.

The current turmoil we are all living through has shown us how interconnected the world is and how deeply we rely on those connections for our very survival. Globally, at least $3 trillion of institutional assets already track ESG scores and the percentage of assets under management. And according to Morningstar, in a time of plunging stock markets ESG investments have fared better than the overall market. In fact, during March, 62% of ESG-focused large-cap equity funds outperformed that index.

This is no surprise to those investors who already integrate ESG into decision making, and over the next months and indeed years all investors will be asking questions of corporates that only ESG can answer.

My advice to corporates? Don't waste this crisis – start to address long-term sustainability trends; embrace the business case for ESG and use it to differentiate your business as the right investment opportunity.

I would like to thank all those who have contributed to this special edition of Reporting Matters; they, like me, passionately believe that a focus on ESG is fundamental to creating better, stronger companies and more stable capital markets.

If you would like to discuss how Luminous can help your company respond to the ESG agenda, then please do get in touch.
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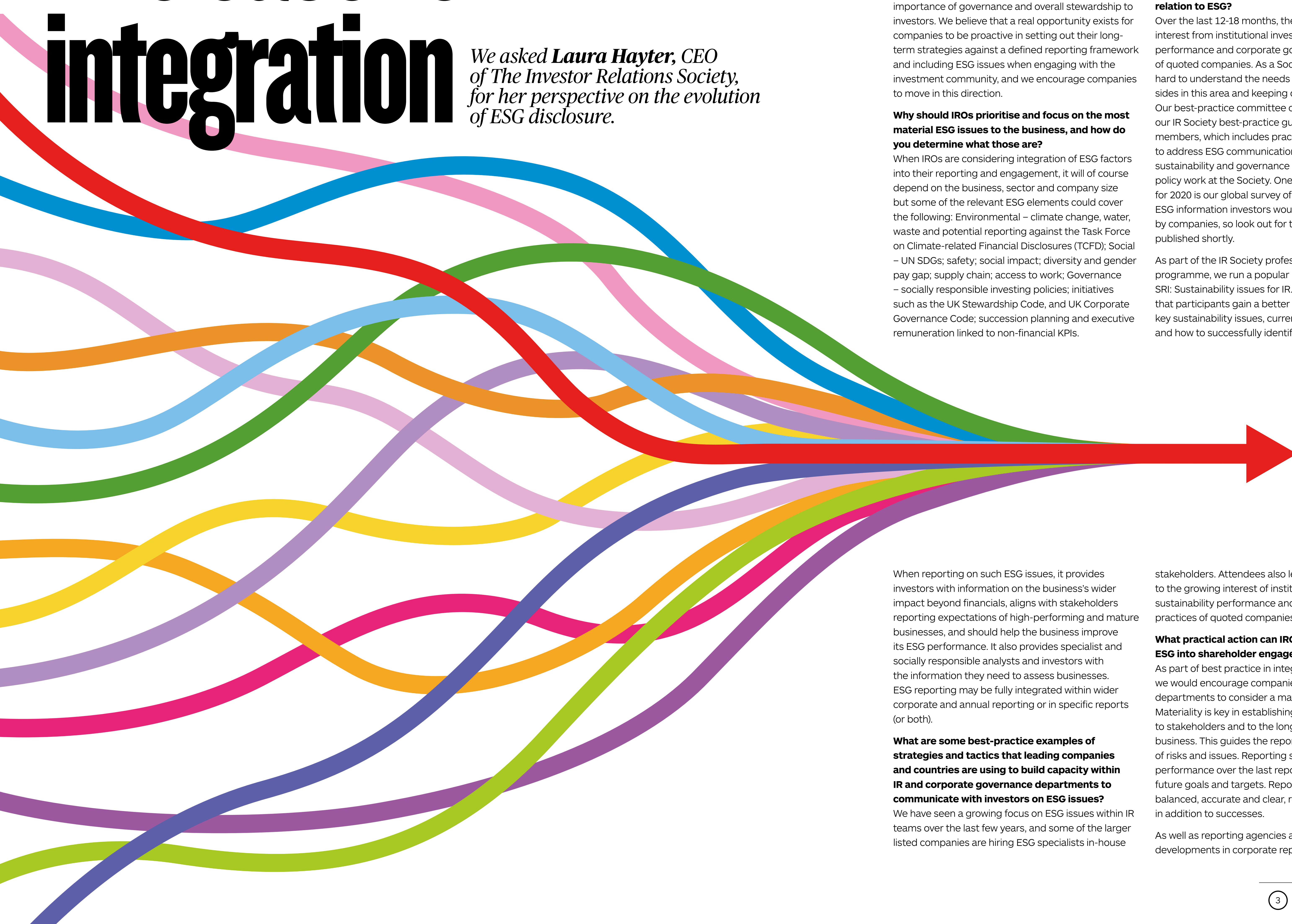
In this issue

The case for integration

Laura Hayter

*We asked **Laura Hayter,** CEO of The Investor Relations Society, for her perspective on the evolution of ESG disclosure.*



Why do Investor Relation Officers (IROs) need to create a compelling narrative on ESG performance that is aligned with the business strategy, and what should that narrative include?
Here at the Society, we believe that a thorough understanding of the ESG issues impacting a business is necessary for long-term value creation. Management of these issues should be an integrated part of business strategy.

Businesses are expected to adopt a more thoughtful approach to wider value and evidence mounts for the importance of governance and overall stewardship to investors. We believe that a real opportunity exists for companies to be proactive in setting out their long-term strategies against a defined reporting framework and including ESG issues when engaging with the investment community, and we encourage companies to move in this direction.

Why should IROs prioritise and focus on the most material ESG issues to the business, and how do you determine what those are?
When IROs are considering integration of ESG factors into their reporting and engagement, it will of course depend on the business, sector and company size but some of the relevant ESG elements could cover the following: Environmental – climate change, water, waste and potential reporting against the Task Force on Climate-related Financial Disclosures (TCFD); Social – UN SDGs; safety; social impact; diversity and gender pay gap; supply chain; access to work; Governance – socially responsible investing policies; initiatives such as the UK Stewardship Code, and UK Corporate Governance Code; succession planning and executive remuneration linked to non-financial KPIs.

When reporting on such ESG issues, it provides investors with information on the business's wider impact beyond financials, aligns with stakeholders reporting expectations of high-performing and mature businesses, and should help the business improve its ESG performance. It also provides specialist and socially responsible analysts and investors with the information they need to assess businesses. ESG reporting may be fully integrated within wider corporate and annual reporting or in specific reports (or both).

What are some best-practice examples of strategies and tactics that leading companies and countries are using to build capacity within IR and corporate governance departments to communicate with investors on ESG issues?
We have seen a growing focus on ESG issues within IR teams over the last few years, and some of the larger listed companies are hiring ESG specialists in-house to address investors and analysts directly in this area. This includes increasing corporate access contact with specialist ESG investors and analysts, and building out communications on company websites to address ESG questions and information. In addition there is a plethora of incoming queries from the ratings agencies (e.g. MSCI, Sustainalytics), which requires a lot of resource and coordination to gather the information internally within a business. We expect IR teams to continue to add specialist ESG resource here.

What support does the IR Society offer IROs in relation to ESG?
Over the last 12-18 months, there has been growing interest from institutional investors in the sustainability performance and corporate governance practices of quoted companies. As a Society we are working hard to understand the needs of the buy- and sell-sides in this area and keeping our members informed. Our best-practice committee continually reviews our IR Society best-practice guidelines, available to members, which includes practical advice on how to address ESG communications. We also address sustainability and governance issues in much of our policy work at the Society. One of our other initiatives for 2020 is our global survey of the buy-side and what ESG information investors would like to see provided by companies, so look out for the results to be published shortly.

As part of the IR Society professional development programme, we run a popular half-day course – ESG/SRI: Sustainability issues for IR. This course ensures that participants gain a better understanding of the key sustainability issues, current and future trends and how to successfully identify and engage with key stakeholders. Attendees also learn how to respond to the growing interest of institutional investors in the sustainability performance and corporate governance practices of quoted companies.

What practical action can IROs take to integrate ESG into shareholder engagement?
As part of best practice in integrating ESG practices, we would encourage companies and IRO/governance departments to consider a materiality assessment. Materiality is key in establishing what issues matter to stakeholders and to the long-term success of the business. This guides the reporting and management of risks and issues. Reporting should also reflect performance over the last reporting period alongside future goals and targets. Reporting should be balanced, accurate and clear, reflecting challenges in addition to successes.

As well as reporting agencies advising on the latest developments in corporate reporting, assurers, such as the large financial audit firms and other specialist consultancies, can help provide advice over non-financial reporting and help reporters improve their ESG reporting.

We are also seeing a lot of information around reporting frameworks, which are wide ranging and it can be hard for companies to know where to start. Reporting frameworks such as the Global Reporting Initiative's (GRI) G4 Guidelines, the International Integrated Reporting Council's (IIRC) Integrated Reporting Framework and the Sustainability Accounting Standards Board's (SASB) Standards help businesses provide comparable, material and complete disclosure.

Finally to complement disclosure and bring the narrative to life, we encourage companies and IR to use mixed media, such as infographics, film, web and social content.

As part of the IRS awards you have a 'Most Effective Integration of ESG' category. What do the winners of this do well?
Now in their 20th year, the IR Society Best Practice Awards provide a meaningful opportunity to showcase best practice, and for the Most Effective Integration of ESG category, winners will be demonstrating evidence a of year-round communication approach to investors and wider stakeholders. They also provide insight into how ESG risks and opportunities are identified, understood, and proactively managed and measured to contribute to a business's competitive advantage, as well as having a positive impact on the employees, associated communities and operational partners.

We recognise that this is a developing area for many companies and each will be at different stage of their journey. What we like to see is businesses demonstrating that their internal approaches are changing and that the ownership of the ESG communication does not rest with one department or team, but that a cross-section of departments works together to deliver a consistent and holistic communication approach to ESG.

Overall, judges applaud companies that have shown evidence of a clearly defined approach, with a consistent and proactive point of view on material ESG issues and long-term value creation across all communications with investors.

ESG will also have even greater importance post COVID-19. In a recent poll conducted by the Society, 86% of respondents noted they expect ESG to become more important as we emerge from the current crisis. Momentum around climate change has rapidly shifted to a focus on human and social capital and the supply chain as a result of the crisis and companies are going to be measured not just on the treatment of shareholders but all stakeholders.

The Luminous view
We agree wholeheartedly with The IR Society. Investors want to understand a company's ESG strategy and how it supports long-term value creation. IROs should give regard to both comparability and materiality when communicating to the markets.

The moment of reckoning

Stephen Butler, *Director of Stakeholder Engagement, outlines why companies need to focus on the social in life after lockdown.*

Stephen Butler

2019 was undoubtedly the year the world woke up to the promise of climate catastrophe.

It was the year Greta Thunberg's words echoed around the world: "You have stolen my dreams and my childhood with your empty words," she said. "The eyes of all future generations are upon you. And if you choose to fail us, I say we will never forgive you. We will not let you get away with this. Right here, right now is where we draw the line."

In 2020 and beyond a reckoning is to be had, as the eyes of the world will be focused not just on environmental issues, but also social ones, specifically on how companies looked after their employees, customers and communities.

And indeed, those businesses that gained our trust through actions and behaviours during this crisis will benefit from increased customer loyalty, enhanced brand and reputation, and will be able to innovate more effectively.

Below we outline the steps companies should take to communicate their social value and impact.

Lead with a social purpose
The pandemic has made it easy to spot those companies that live their purpose vs those who see it merely as a tagline.

A purpose is a key tool for building trust with employees, customers and communities. And there have been some great examples of leading with purpose in recent weeks:

- Fashion house Burberry making masks and gowns for the NHS, in the Yorkshire factory where its trademark trench coats are made.
- Morrisons changed its core purpose to provide reassurance to customers during the COVID-19 pandemic and reflect the extent of the role it sees itself playing in 'feeding the nation'.

At Luminous, we believe that by getting purpose right and incorporating the most impactful sustainability issues, businesses are better placed to meet the demands and challenges of an uncertain future.

In short, if you create a strong corporate purpose underpinned by sustainability goals and targets, and hire staff who believe in your proposition, the benefits of implementing purpose – and sustainability-driven measures – far outweigh any costs.

Our approach starts with a simple yet powerful question:

What role can you play in developing a sustainable world?
We help corporates answer that question to derive an authentic, credible and future-facing purpose, across the nexus of:

- global megatrends
- cultural context and business reality
- brand and values
- sustainability strengths, issues and impacts.

If your purpose answers these questions, you are on to a winner; if not, then it's time to re-evaluate.

Do the right thing by your stakeholders
How companies treat their employees and suppliers will receive scrutiny over the months to come. In fact, in April Legal & General Investment Management (LGIM) warned it would hold companies to account if they fail to treat their stakeholders well.

Sacha Sadan, head of investment stewardship at LGIM, said the COVID-19 crisis would strain social and financial systems significantly, but also highlight how companies looked after various stakeholders.

"We encourage companies not to focus solely on their shareholders but to focus on stakeholder primacy and include all stakeholders, especially their employees, supply chain relationships, the environment and the communities in which they operate," he said.

We would recommend firms consider what policies and actions they might take to bolster their social credentials, by answering the following questions:

- How are you supporting employees during the crisis?
- What are the cost implications of human capital decisions being made?
- Are there union or contractual obligations that may impact the decisions made around human capital management?
- What efforts are being taken to ensure that employees remain engaged? If working conditions have changed, what steps have been taken to ensure employees can remain productive and efficient?
- What actions has the company taken to support customers who may be facing financial challenges as a result of the COVID-19 disruption?

Show leadership
The 2020 Edelman Trust Barometer Spring Update: Trust and the COVID-19 Pandemic reveals that half of the people believe business is poor, mediocre or completely failing at putting people before profits; only 43% believe that companies are protecting their employees sufficiently from COVID-19, and 46% do not believe business is helping smaller suppliers and business customers stay afloat.

The report goes on to say that the poor performance of the business during the COVID-19 crisis is further seen in the lacklustre assessment of CEOs. Fewer than one in three respondents (29%) believe CEOs are doing an outstanding job responding to demands on them placed by the pandemic compared with scientists (53%) and government leaders (45%).

Empathy-driven leadership is critical to communicating well and building trust during challenging times, by clearly communicating colleagues' safety, explaining their response, conveying uplifting stories, demonstrating purpose before profits, and providing reassurance to investors by emphasising the resilience of their strategies and business models.

Report the data
It's fair to say that the S in ESG has been the weak link in investment analysis so far, as investors have lacked a shared framework to assess companies' approaches.

As companies begin to report on their social aspects, it will require a mix of qualitative and quantitative information.

A good starting point is the SASB which provides a useful materiality map for social activities by sector.

More broadly, however, companies should report on how COVID-19 has impacted stakeholders engagement and decision making. To help achieve this, we would recommend that companies consider the following:

- How are management and the board adapting their stakeholder engagement strategy in light of the crisis? Were new mechanisms of engagement introduced?
- How is the board engaging with the workforce during the period of remote working?
- How is COVID-19 influencing the views/priorities of key stakeholders? How is the company gaining input and insight on these and factoring them into its response to the crisis?
- What principal decisions are being made during this time? How has the board considered the impacts of these on stakeholders, including the company's efforts to mitigate/minimise adverse consequences? e.g. furloughing employees vs redundancies, delaying supplier payments vs reducing payments, pausing investment in certain projects vs cancelling the investment?

COVID-19 will shape ESG investing. Clearly outlining your company's ESG approach and strategy will no longer be a 'nice to have', but an essential part of the engagement with investors and capital providers.

To discuss how Luminous can help you with your ESG reporting, drop me an email:
stephen.butler@luminous.co.uk

The business case for ESG

***Bronagh Ward**, Senior Associate at KKS Advisors, tells us how companies can act on the business case for ESG.*

The ability to quantify a positive link between corporate ESG efforts and financial performance is at the centre of revolutionising the economy and bringing sustainability to the top of the agenda for corporate leaders. Today, we have a much deeper understanding of the financial implications of ESG than we had just a decade ago. In short, we now know that ESG issues are connected to better financial performance (when companies focus on the specific issues most relevant to their business and industry), and that investors use ESG data and company performance rankings to allocate capital, minimise risk and optimise returns. This knowledge is reshaping how senior decision makers think about strategy, competitiveness and value creation.

A key milestone in the sustainability realm occurred in 2014, when leading academics, including George Serafeim (co-founder of KKS Advisors and Professor at Harvard Business School), demonstrated that a portfolio of companies with better sustainability performance generated significantly higher financial returns over an 18-year period than a similar portfolio with poor sustainability performance[1]. This evidence helped challenge the assumption that investors and companies would have to sacrifice returns in exchange for social and environmental outcomes and accelerated interest in ESG in the private sector.

More evidence supporting the idea that ESG is good for business continues to emerge. A recent analysis of the banking industry conducted by KKS Advisors found that firms with good ratings on industry strategic sustainability issues delivered significant financial outperformance over firms with poor ratings on the same issues[2]. BlackRock – the world's largest institutional investor – has weighed in on the topic too, publishing research dispelling the myth that a return sacrifice is needed when adopting sustainable investing, arguing that in fact the opposite is true[3]. According to BlackRock, the full consequences of a long-term shift to a more sustainable economy are not yet reflected in market prices, and a return advantage can be gained during the transition. Additionally, early evidence following the outbreak of the COVID-19 pandemic has shown that ESG funds have been more resilient to the market downturn, reinforcing the view that ESG is not a 'nice to have' during good times, but is in fact critical to better economic performance even during a market downturn[4].

If ESG matters to financial performance, then what do companies need to do about it? In our experience of working with clients on sustainability strategies and reporting, a three-step strategy model is needed: (1) Communicate the business case, (2) Prioritise the most relevant ESG issues, and (3) Measure and track progress.

Bronagh Ward

1. Communicate the business case

A first key step is to understand the business case and drivers for action, which for many companies begins with looking at the growing demand for ESG from their investor base. It is important to know that companies are being ranked on ESG disclosure by investors and by third-party ESG scoring providers, and that choosing not to disclose certain information will likely hurt your score. State Street Global Advisors, another of the world's largest institutional investors, has been urging boards of directors to pay attention to ESG scores, noting that "a company's ESG score will increasingly determine if trillions in global institutional and retail capital will flow toward them or away from them"[5]. It is important to note that to generate the level of buy-in needed to integrate ESG successfully across an organisation, the business case should be communicated to key stakeholder groups across the organisation, and it must resonate with each of them. The board, and investor relations and sustainability teams are three groups that will each bring distinct perspectives and respond to different incentives.

Companies that have identified the right key issues for their business can start to measure their progress and, over time, drive performance gains

2. Prioritise the most relevant ESG issues

Once the business case is well understood, companies that are truly committed to ESG will start to drive strategic performance upgrades across their business. To get there, the second step in the process is the identification of the most relevant ESG issues linked to the business model and industry that should be prioritised. Certain issues are more likely to impact financial and operational performance and therefore will be more important to investors. Given the vast universe of ESG issues that exist, it is essential to go through this prioritisation exercise in order to be efficient. For example, a good employee health and safety record is important for mining companies to retain their social licence to operate, while effective systemic risk management is more important for large financial institutions to ensure resilience. Too many companies find themselves lost among the multitude of existing ESG disclosure frameworks and as a result are pulled in many different directions without a guiding compass.

3. Measure and track progress

Companies that have identified the right key issues for their business can start to measure their progress and, over time, drive performance gains. Here, it is important to focus on quantifiable metrics which can be tracked and plugged into financial models. Some of the areas where companies typically find value from sustainability include direct costs savings (e.g. from energy efficiency), increased customer loyalty, increased staff retention rates and lower cost of capital.

Going forward, the trend towards sustainability is set to intensify as investors and regulators step up their oversight of corporate sustainability disclosure and performance. It will be further intensified by pressure from the general public, the scientific community and NGOs, who are raising awareness on key issues such as climate risk – an issue which is projected to have severe impacts on the global economy within the next decade. Yet a simple truth is that many business leaders are currently missing opportunities to derive economic value from ESG. Sooner or later, companies that are proactive in embracing sustainability will ultimately be rewarded by the market. Overall, there can be no doubt that ESG matters and is here to stay.

The Luminous view

As KKS Advisors say, the business case is clear. COVID 19 has escalated ESG adoption, and there is clear evidence that ESG stocks are outperforming the market. Companies large and small must develop a clear ESG strategy.

1 Eccles, Ioannou, and Serafeim (2014). The Impact of Corporate Sustainability on Organizational Processes and Performance. Management Science, Volume 60, Issue 11. Source: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1964011
2 KKS Advisors and Global Alliance for Banking on Values (2019). Do Sustainable Banks Outperform? Source: https://www.kksadvisors.com/do-sustainable-banks-outperform
3 BlackRock (2020). Sustainability: The tectonic shift transforming investing. Source: https://www.blackrock.com/us/individual/insights/blackrock-investment-institute/sustainability-in-portfolio-construction
4 Financial Times (2020). ESG shines in the crash: legal milestone for ratings. Source: https://www.ft.com/content/dd47aae8-ce25-43ea-8352-814ca44174e3
5 State Street Global Advisors (2019). What's your ESG Score? Source: https://hub.ipe.com/download?ac=83644

TAKING THE LONG-TERM VIEW

Hannah Armitage and ***Claudia Chapman*** of the Financial Reporting Council (FRC) explain why TCFD is so important for climate risk reporting and how the revised UK Stewardship Code will help drive better integration of ESG into investment decision making.

Hannah Armitage

Claudia Chapman

What were the main findings of the FRC Financial Reporting Lab's report into climate-related corporate reporting, and are companies falling short of investor expectations?
Hannah Armitage (HA): The Financial Reporting Lab's project on climate-related corporate reporting highlighted that there is a lot of support in the market for disclosures according to the TCFD recommendations.

The TCFD framework consists of four elements: governance, strategy, risk management, and metrics and targets. While the Lab's project did not use the TCFD as a starting point for our discussions, it became clear very quickly that companies and investors were supportive of the framework for thinking through and reporting on climate-related challenges. Because of this, the Lab's report is based around these four elements.

Investors are really interested in this issue. In fact, of all the Lab's projects over the past nine years, this one attracted the highest number of participants. Investors view climate change as relevant to a wide range of businesses, with many believing that companies should consider it to have a material impact.

For this project, we looked at disclosures from 2018 and 2019 by companies across the world. We spoke to companies and investors as well auditors, advisers, sustainability experts and communication agencies.

In terms of reporting, this is very much a developing practice. It's fair to say there are different levels of sophistication. Investor participants told us that insight into whether the business model remains sustainable, the importance of disclosures on scenario analysis, and the strategic alignment, reliability and transparency of disclosures are key.

What steps should boards take to integrate climate risks into their reporting?
HA: In some ways it's a very new challenge, but on the other hand, many companies already have robust risk management processes in place and climate risks should form part of these existing processes. There's a lot of uncertainty around climate change outcomes but it's important that boards don't see this as an entirely separate issue and instead think through scenarios of how the business might be impacted, either in the shorter or longer term, and how they plan to respond.

There are 11 recommended disclosures under the TCFD framework, as well as a set of questions defined by the Lab's project, that investors are asking companies – and therefore questions that companies should ask themselves.

Boards aren't necessarily expected to have the answers straight away and different companies will be affected in different ways. However, a great starting point is to begin to explain to investors how a company's management and governance systems are addressing climate-related challenges, the biggest challenges the company might face and how they could begin to address those challenges.

The Lab's report recommends that companies use TCFD as a framework for thinking about and reporting on climate change. What advice would you give to preparers who want to start using the TCFD framework?
HA: The TCFD is a really useful resource, so use it! The 11 recommended disclosures of the framework are high level, which means that companies can still tell their own story within the framework.

That's not to say it's straightforward. There are challenges to following the TCFD framework: trying to get to grips with what this means for a company can be tricky and uncomfortable, as elements of the impact of climate-related challenges on companies remain uncertain. However, investors are keen for companies to disclose more information on this issue. The Lab's report, which is framed around the TCFD, also includes a set of questions companies should ask themselves in thinking about these issues and developing their reporting. Hopefully these provide a useful starter for companies struggling to work out what to report.

One of the regulatory elements that companies should be aware of is the Green Finance Strategy published in 2019, which states that the Government's expectation is for listed companies and large asset owners to be disclosing against the TCFD framework by 2022. Implementation options are still being considered, but there's a clear direction of travel for the expectations around reporting.

The FRC has launched a thematic review across a number of its functions, which will, in part, highlight best practice against the TCFD framework. Regulatory change is moving quite quickly in some jurisdictions and we're seeing lots of global best practices, so we want to highlight these to assist companies to improve their reporting.

What is the UK Stewardship Code and how does it encourage investors to consider ESG factors?
Claudia Chapman (CC): The revised UK Stewardship Code, which took effect on 1 January 2020, is a voluntary code of best-practice principles for asset owners such as pension funds and insurers, investment managers, and service providers such as proxy advisers, investment consultants or – increasingly – those that provide data and information particularly in relation to ESG.

The principles are truths or beliefs about the activities and behaviours that underpin effective stewardship. For example, "Signatories systematically integrate stewardship and investment, including material ESG" and "Signatories actively exercise their rights and responsibilities." If you do these things, you'll be an effective steward of the assets entrusted to your care.

In revising the Code, the FRC redefined stewardship through extensive consultation with a broad range of stakeholders – including pension funds, NGOs, industry bodies, asset managers and other regulators. Stewardship is now a much broader set of activities and behaviours, intended to benefit clients and beneficiaries, leading to sustainable benefits for the economy, the environment and society. Every aspect of stewardship should take this new definition into account and this puts ESG issues at the heart of the Code.

How can the Code drive better reporting, and what are the ESG-specific reporting expectations?
CC: Originally, the Stewardship Code's primary focus was on making sure UK-listed companies performed well and were well governed, and in turn the capital invested by pensioners and savers would be protected and grown. When we revised the Code this time, we changed the primary purpose of the Code and stewardship to be to be in the interest of UK pensioners and savers.

Although there's a drive from asset managers themselves to focus on climate change, they are also being pushed by their underlying asset owners to focus more on climate change and other ESG issues – and that's been driven by legislation, too. There's a long-term benefit to companies, the economy, the environment and society by focusing on ESG.

The Luminous view
We agree that reporting against TCFD is becoming an essential tool in understanding climate risks and costs. When done well, it improves decision making and achieves enhanced market resilience and more sustainable economic growth.

Climate-aligned investing: what, why and how

***Sophie Lawrence**, Senior Ethical, Sustainable and Impact Researcher at Rathbone Greenbank Investments, tells us how investors can better achieve climate-aligned investing.*

Sophie Lawrence

> **"Carbon emissions have to decline by 45% from 2010 levels over the next decade in order to reach net zero by 2050. This requires a massive reallocation of capital. If some companies and industries fail to adjust to this new world, they will fail to exist... climate change is a global problem, which requires global solutions, in which the whole financial sector has a crucial role to play."**
> Open letter from the Governor of Bank of England Mark Carney, Governor of Banque de France François Villeroy de Galhau and Chair of the Network for Greening the Financial Services Frank Elderson

Climate change is an existential threat to humanity, the global economy and our planet's entire environmental system. At the United Nations Framework Convention on Climate Change's (UNFCCC) Paris Climate Change Conference in December 2015 (COP 21), 195 countries adopted a global, legally binding agreement on climate change.

The Paris Agreement commits signatories to a number of goals, including holding the increase in the global average temperature to well below 2°C above pre-industrial levels and pursuing efforts to limit this to 1.5°C. The Intergovernmental Panel on Climate Change (IPCC) is the UN body dedicated to providing the world with an objective, scientific view of climate change. Its 2018 report highlighted the need to remain below 1.5°C of warming in order to avoid significant environmental and economic costs. Yet current global policies and company targets are projected to result in over 3°C of warming. This year's 'State of Transition' report, which is published annually by the Transition Pathway Initiative (TPI), found that, of a total 238 of the highest-emitting listed companies assessed, more than 80% remain off track for a 2°C world. The ambition gap needs to close, and fast.

Achieving the Paris goals requires both the public and private sector to take action to limit greenhouse gases. The necessary transition to a low-carbon economy will create disruption across a range of industries. There will be winners and losers. The physical risks of climate change, such as sea level rise and extreme weather, will also result in widespread economic impacts. These risks are not homogenous and will materialise at different times and at different levels of severity. However, it is clear that delaying action will only increase the likelihood of severe economic shocks and irreversible environmental damage. Despite a series of stark warnings, the market has not yet fully integrated the risks and opportunities associated with a changing climate. In fact, the 2020 'Banking on Climate Change' report, which assesses the fossil fuel financing activities of banks, found that 35 private sector banks have not only been sustaining but expanding their financing of the fossil fuel sector by more than $2.7 trillion in the four years since the Paris Agreement.

In order to limit warming to 1.5°C, global carbon emissions will need to fall dramatically by 2030 and achieve net zero by 2050. Investors have an important role in directing capital in a way that can support these outcomes. Aligning a portfolio to both support and benefit from this transition may also help to insulate it from medium and long-term risks and position it to capitalise on long-term opportunities.

There are a number of steps investors can take to align their portfolios to this pathway:

- Reduce exposure to industries whose activities are misaligned to a low-carbon pathway – for example companies involved in coal or oil extraction or those operating coal-fired power plants. Exposure to other high-carbon industries should also be considered, such as non-electric automobiles, airlines, etc. Reducing exposure may involve full, partial or targeted divestment and decisions should give consideration to an organisation's current climate impacts and whether it has a credible transition strategy.
- Increase exposure to industries and companies that are either directly or indirectly contributing to climate change mitigation and adaptation. Direct contributors include renewable energy and energy efficiency. Indirect contributors include companies that are reducing their greenhouse gas emissions year on year or providing technology, products and services that facilitate the low-carbon transition.
- Assess the exposure of investment portfolios and holdings to climate risk. This can be done through collecting data on the greenhouse gas emissions of underlying holdings to produce a carbon footprint or by measuring their exposure to carbon-related assets.
- Engage with companies and policy-makers to encourage actions consistent with a low-carbon transition (see case study box). This engagement can range from informal dialogue through to more formal measures such as meetings with company boards and voting on AGM resolutions.

In summary, investors can act by decarbonising their investment portfolios and increasing their investment in climate solutions. And, with time running out to achieve meaningful action, collaboration and co-ordination among global investors is key.

If you want to find out more about our work at Greenbank, please visit our website or you can get in touch with Sophie directly.

Case study
The Paris Aligned Investment Initiative

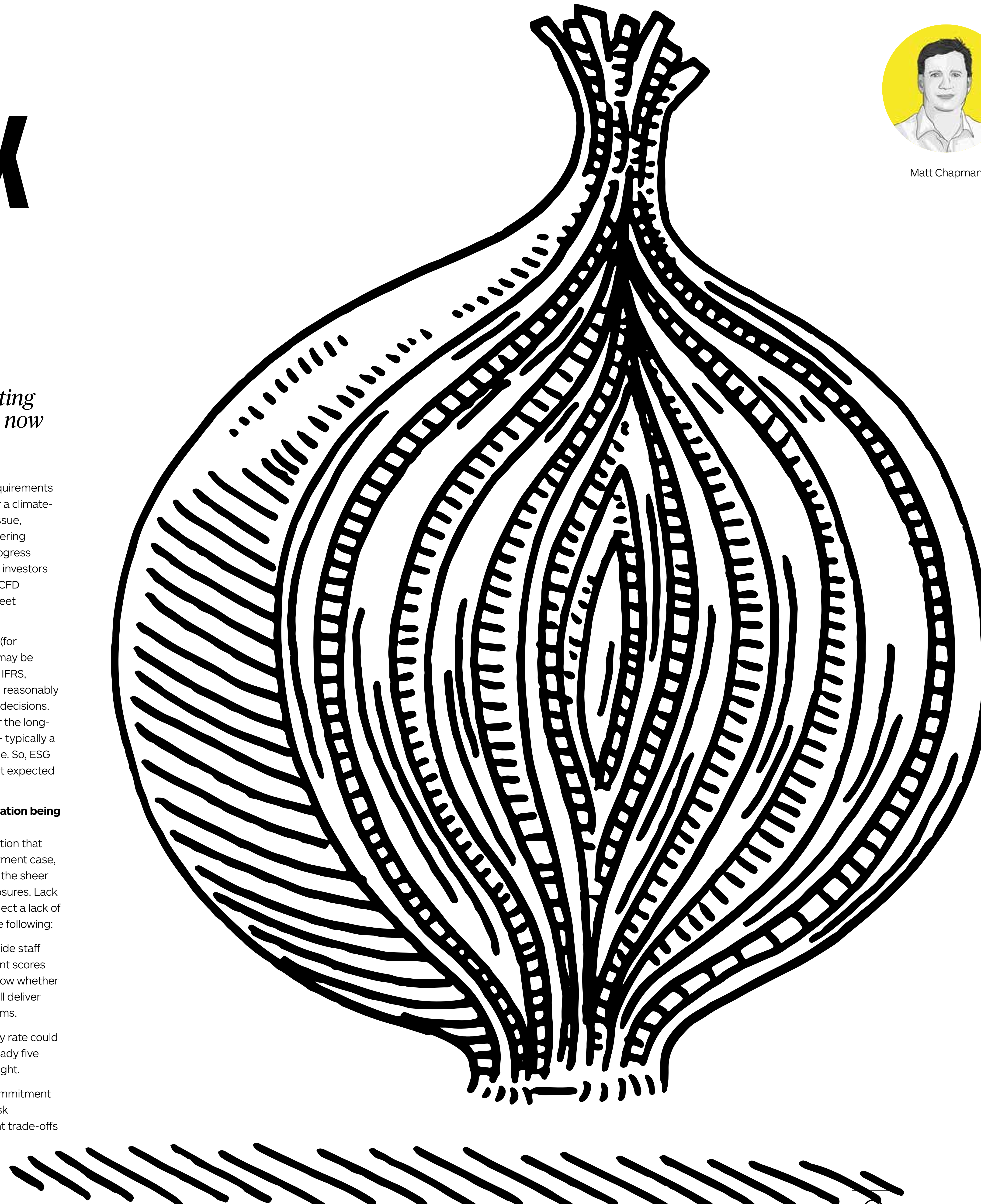
This initiative is led by the Institutional Investors Group on Climate Change (IIGCC), a forum for collaboration among European investors, including Rathbone Greenbank Investments. The aim is to develop a commonly accepted definition of Paris alignment for investors and establish consensus on the potential methodologies and approaches that investors can use to track alignment and the transition of a portfolio over time. The draft framework is expected to launch in June 2020.

The Luminous view

The impacts of climate change constitute a risk for asset owners and asset managers, and the financial community at large. Climate risks are long-term risks which short-sighted markets fail to price because there are no incentives to fix them for current financial actors driven by short-term indicators. The role of investors in solving the challenge cannot be underestimated. They have a key role to play in providing capital to companies that are focused on creating long-term value for all stakeholders. They also must act as good active stewards of those companies.

Peeling back the layers

*We asked **Matt Chapman** of the Better Business Reporting Group at KPMG, about the greater insight investors are now demanding about ESG in corporate reporting.*



Matt Chapman

Q: How is ESG reporting practice developing?
ESG reporting is maturing as it moves into the mainstream of corporate reporting. In the past it was perhaps enough that companies could demonstrate an interest in the right topics. However, more pointed questions are being asked now. If a company's prospects are affected, then investors need to be able to assess potential effects and understand the company's strategy and progress managing the matter. That information belongs in an annual report, whether it relates to an ESG factor or any other operational matter.

Managing the development of ESG reporting requires a focused approach. That means providing more information on the specific ESG factors that drive the company's success and less on those that have a peripheral impact. Investor-focused frameworks such as those provided by TCFD (on climate factors) and SASB (on a range of ESG factors) can help companies deliver this, but they require thoughtful application rather than slavish disclosure.

For preparers, this means that subject matter expertise needs to be combined with knowledge of the company's wider strategy and success factors, and an understanding of exactly what information would affect an investor's decisions.

Q: How should annual reports address climate risks?
KPMG's publication, Climate in the annual report (https://home.kpmg/uk/en/home/insights/2020/01/climate-in-the-annual-report.html) discusses how companies can approach IFRS and strategic report requirements in their annual reports.

The starting point for addressing climate reporting should be an understanding of where the company's risks and opportunities lie. That may seem obvious, but the volume of climate-related disclosure requirements can drive companies towards a checklist approach.

There are of course explicit climate disclosure requirements such as carbon emissions that need to be met by law. However, it's the implicit requirements that are likely to be the most significant for a climate-exposed business. If climate is a material issue, then the Companies Act requirements covering the business model, risks, strategy and progress should drive the front-end disclosures that investors need to assess the issue. We believe the TCFD recommendations may help companies meet these requirements.

In some cases, financial statement effects (for example, asset impairment) or disclosure may be relevant. Where a disclosure is required by IFRS, information is treated as material if it could reasonably be expected to affect investors' economic decisions. ESG matters will often raise questions over the long-term sustainability of the business model – typically a substantial proportion of a company's value. So, ESG factors may be material even if they are not expected to crystallise for several years.

Q: What about the quality of ESG information being reported?
Although there's plenty of investor recognition that ESG factors can be important to the investment case, there's also a great deal of frustration with the sheer volume and vagueness of many ESG disclosures. Lack of reporting clarity is often assumed to reflect a lack of strategic clarity. Common signs include the following:

- Over-aggregation: It's great if your firm-wide staff retention rates and employee engagement scores are stable, but investors really need to know whether you're holding onto key personnel who will deliver future growth, such as R&D or design teams.
- Missing track record: A low lost-time injury rate could mean little on its own, but as part of a steady five-year decrease, it can provide genuine insight.
- Isolated discussion: A net zero carbon commitment may help to address long-term climate risk exposures, but it can also entail significant trade-offs for the wider business. Investors need to assess both the positive and negative implications of the choices being made on their behalf.

The reality is that many companies' ESG reporting systems are in the early stages of development and typically rely on manual intervention and complex spreadsheets. However, that is starting to change. Boards are responsible for the accuracy of market-relevant information whether it relates to an earnings number or a measure of ESG performance. So we are seeing audit committees paying much more attention to the quality of material ESG information and benchmarking it against the controls and reporting standards set for financial information.

Q: What role could auditors play?
Firstly, some ESG information may feature in the audited financial statements, for example because it's needed to understand a key accounting estimate or judgement.

Information in the strategic report is not audited, but the auditor will nevertheless read the other information and consider whether it is materially misstated or inconsistent with the financial statements or their audit knowledge if an issue is identified. In this case, companies will typically choose to amend their strategic reports prior to publication, so the auditor's contribution may not be visible to users.

Companies are increasingly asking the auditor to go further, requesting assurance over specific non-financial disclosures in the annual report. Typically this will start with private assurance to give the board greater confidence over the process behind those disclosures, and often leads to public assurance opinions where the quality of reporting systems/processes supports this.

One regulatory approach to the question of wider assurance would be to place the cost-benefit judgement over the value of assurance in the hands of investors. For example, the Brydon Review into the quality and effectiveness of audit, published in December 2019, called for mandatory independent assurance over non-financial KPIs linked to directors' remuneration. Additionally, the review advocates for investors to have a right to request extended assurance over other non-financial information – for example, if they have concerns over the quality of information they are receiving. Increasingly, both of these areas include ESG measures such as indicators of climate exposure, water usage or health and safety metrics.

The Luminous view
We agree that having the right ESG data is essential to a company's performance. Having a degree of assurance may be beneficial for boards and investors.

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