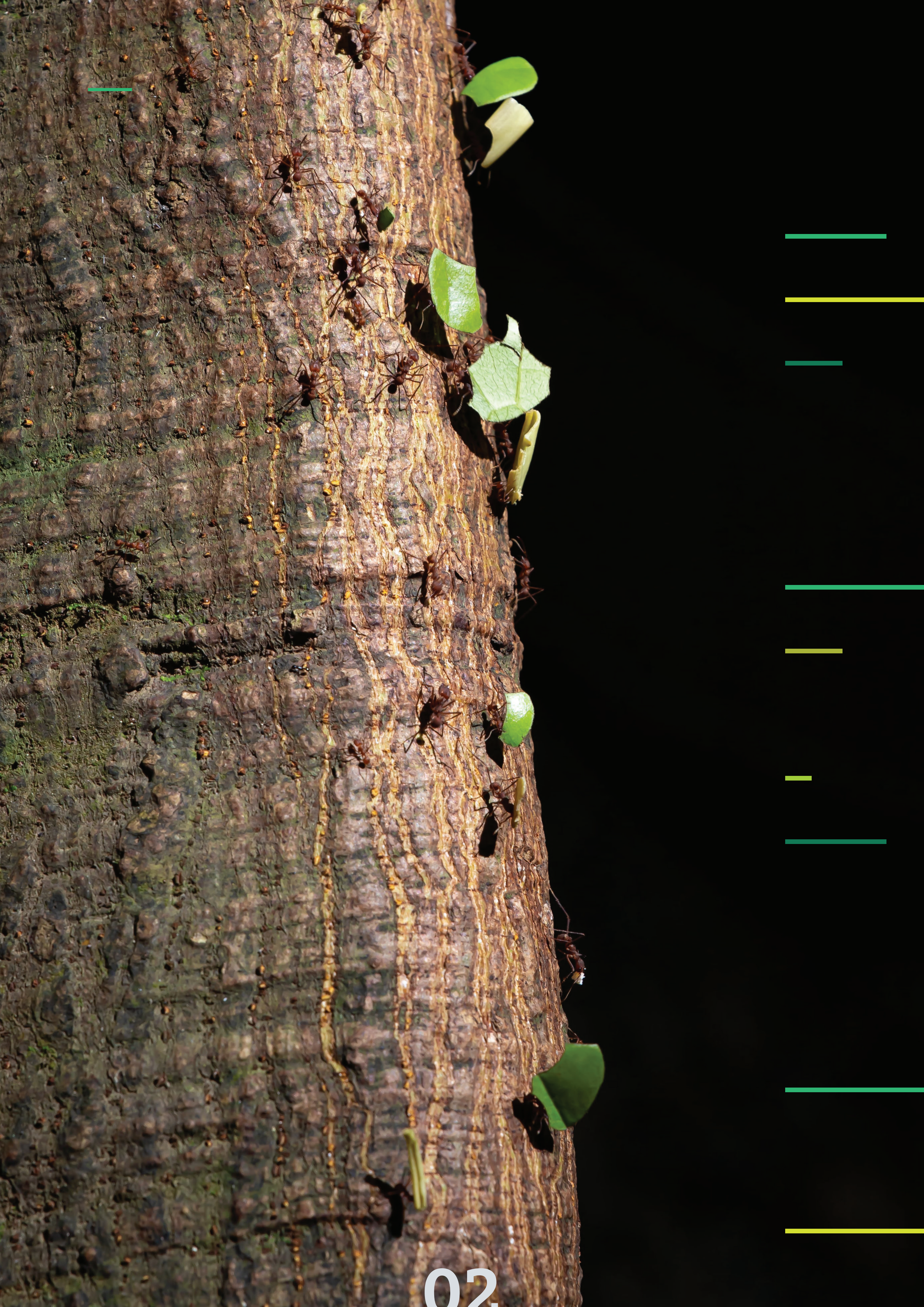
ESG & Climate Compliance

NEW RULES FOR STEERING

White Paper – April 2021



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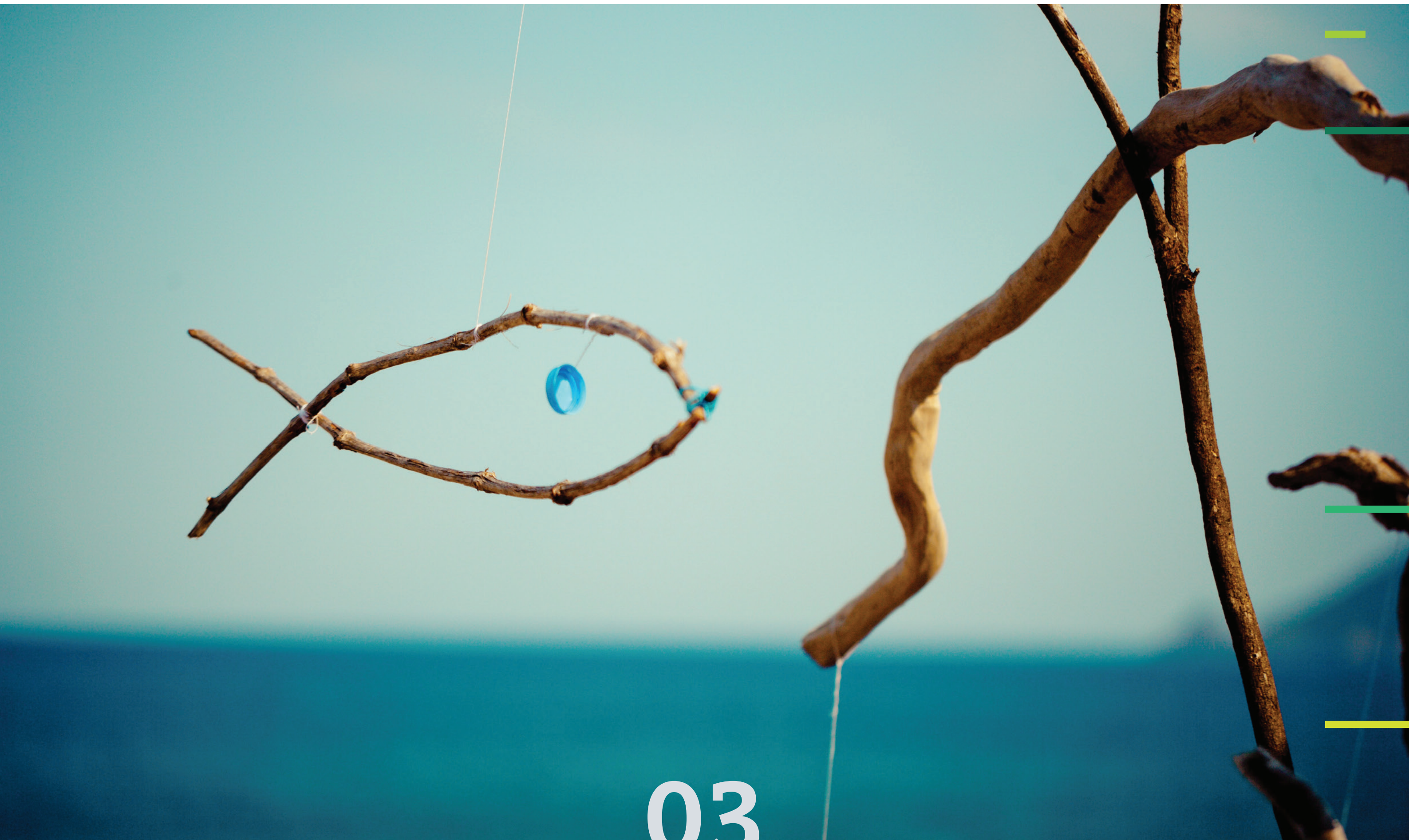

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Introduction

There is compelling evidence that corporate performance regarding environmental, social, and governance (ESG) risk contributes to business performance, and that the relationship persists over time. The reasons are relatively simple: Awareness of ESG factors is rising fast, and people want to do business with companies that share their values. Furthermore, the emergence of new data and analytical tools means stakeholders can closely monitor ESG impacts and respond quickly when there are failures.

Alongside rising consumer and investor pressure, the green regulatory agenda is picking up momentum. Since 2018, there have been over 170 new or amended ESG regulations proposed globally - more than in the previous six years combined.[1] The European Union, for example, has launched initiatives across numerous policy areas. (See Figure 1). When reporting on ESG matters, meanwhile, companies are increasingly required to follow guidelines published by the Task Force on Climate-related Financial Disclosures.

There is little doubt that corporate activities will be increasingly shaped by ESG concerns. Despite this looming challenge, however, most businesses have yet to develop a systematic approach to oversight and risk management. To accelerate their transition, we see three essential steps. The first is to undertake an ESG factor and materiality assessment, through which the company can pinpoint the ESG topics most likely to have an impact on the business. The next is to establish a regulatory footprint, based on activities and operational exposures around the world, including in the supply chain. Finally, businesses require a dedicated ESG & climate compliance target operating model, which will govern matters including strategy, governance, and risk management. Two important aspects of the model are implementation of ESG compliance controls and reporting, and we deep dive into those topics below.

In conclusion, ESG is set to become a key focus for corporate decision makers and stakeholders. To manage the risks, and opportunities, business leaders need dedicated controls and steering capabilities. These will create a sharper lens through which to view exposures, and a reliable framework to govern compliance, oversight, and risk management.

1 ESG regulations and their impact on advice, FT Adviser, May 2020.

Companies Face an ESG Challenge

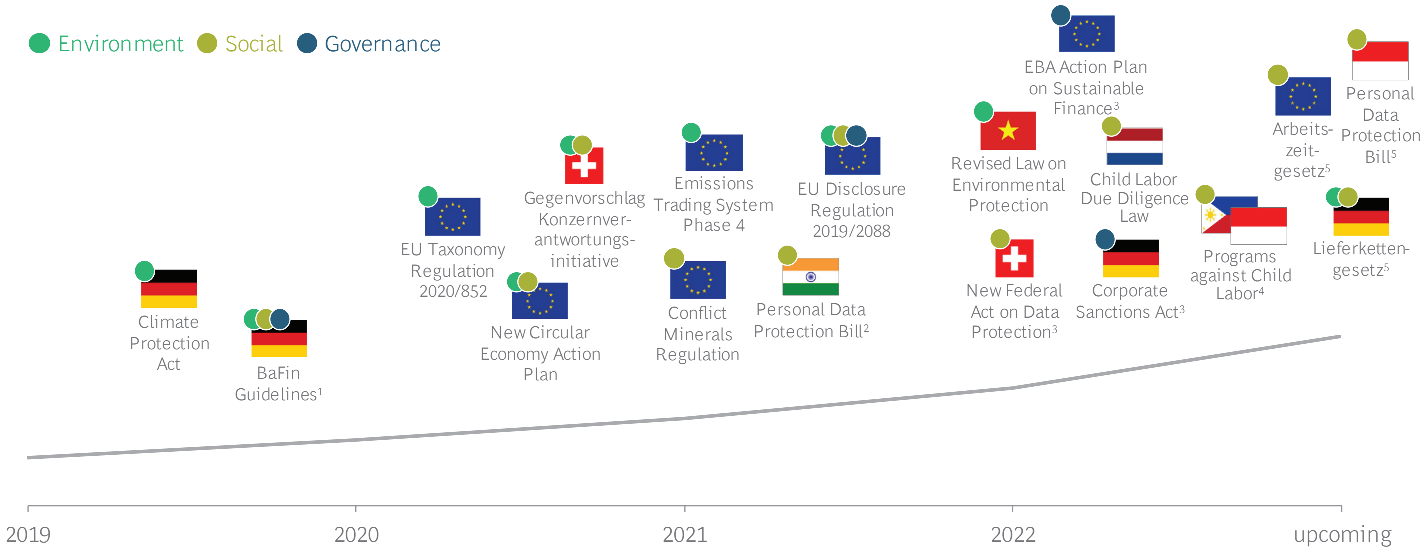


Figure 1: Global ESG regulation is set to ramp up in the coming years

1. BaFin Merkblatt zum Umgang mit Nachhaltigkeitsrisiken 2. Expected to be effective 2021 3. Expected to be effective 2022 4. Full implementation expected in 2022 5. Upcoming regulation

Source: BCG research

The majority of corporate decision makers are aligned with the momentum behind ESG and are taking action to ensure their organizations operate based on ESG principles. However, the urgency of the topic is creating challenges. For example, there is no uniform taxonomy or market standard for ESG, meaning that companies and their stakeholders can lack a common language to discuss issues or benchmark their progress. As a result, they are required to “fly blind”, aligning with ESG factors based on what they pick up from day-to-day.

Given these structural challenges, corporate ESG & climate compliance is often rolled out chaotically, with controls spread across strategy documents, press releases, and reports. In many cases, ESG compliance is seen as the narrow responsibility of the Chief Sustainability Officer or communications department. Senior manager involvement, meanwhile, is often limited to sign offs or strategy. This state of affairs can heighten the chances of regulatory breaches, or of ESG risks materializing in some aspect of the business.

A common underlying cause of ESG compliance shortfalls is the fact that companies have not paid sufficient attention to the core frameworks that underpin their operations. In short, the structures that dictate how ESG factors are monitored and managed are not sufficiently equipped for the volume and variety of new requirements, both in terms of compliance and reporting.

To manage ESG & climate compliance effectively, a more systematic approach is required, based first a thorough assessment of the company’s risk exposures, and backed by a comprehensive regulatory review. These steps will lay the foundations for an ESG compliance target operating model that is fit for purpose.

Assessing ESG Factors and Materiality

Regulators have called on companies to take a risk-based approach to ESG & climate compliance, meaning that they should focus on risk outcomes and prioritize their actions based on an assessment of likelihood and potential impact. An essential tool to achieve this is a "dictionary" of ESG factors, containing ESG definitions that are relevant to the company and members of its value chain.

In identifying relevant factors, many companies make an early commitment to the UN Sustainable Development Goals. These can act as guiding principles that reflect the company's core values. From there, decision makers may choose to leverage one or more of the many industry resources that can help them specify the ESG factors relevant to their activities. The International Standards Organization's ISO 26000, for example, contains guidance on social responsibility that aims to help businesses and organizations translate principles into effective actions. The document provides a list of topics that can be used to inform ESG factor decisions, including relating to human rights, labor practices, the environment, and fair operations. The OECD, meanwhile, has published its Guidelines for Multinational Enterprises, focusing on responsible conduct. The Sustainability Accounting Standards Board also has substantial range of resources.

Based on these inputs, BCG recommends a factor database that is structured in line with the tripartite E, S, and G formulation. (See Figure 2). Once these are in place, it makes sense to subdivide the three categories into more specific topic areas – for example, relating to resource consumption or environmental damage. These will act as a point of reference for ESG-related activities and ensure a common understanding across the organization.

The final step is to focus on the potential impacts of ESG factors, which can play out as physical risks (for example, damage from flooding or extreme weather) or transition risks, relating to the company's business model. A common example of the latter is the shift away from fossil fuels, which has obvious potential impacts on the energy industry. These efforts will cumulatively enable the company to create a comprehensive reference document for its ESG risks, related opportunities, and compliance activities.

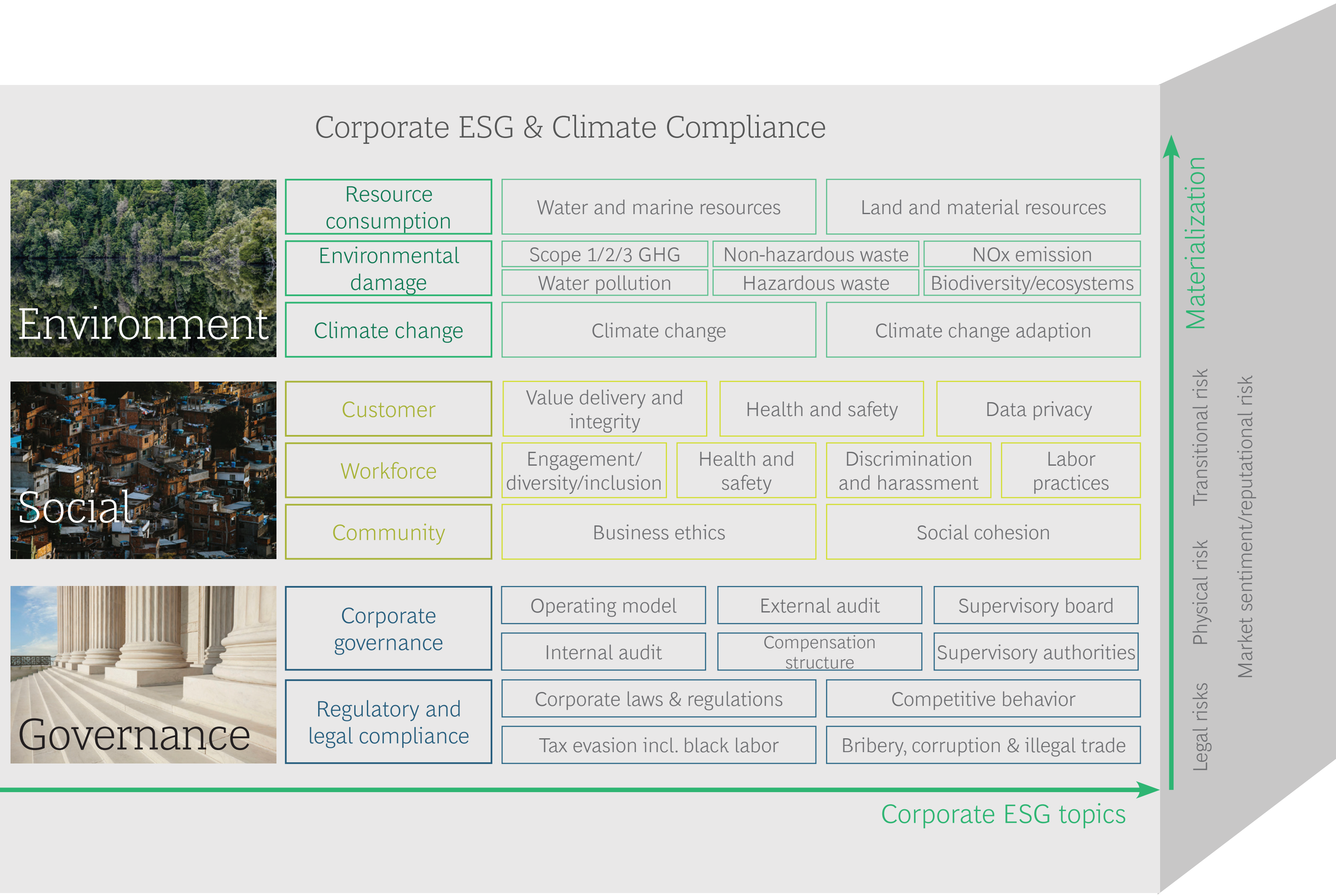


Figure 2: Corporate ESG and Climate Compliance

Note: Systematically defined in line with global sustainability definitions.

Source: BCG

Establishing a Regulatory Footprint

Over the next few years, a significant number of ESG-related regulations are coming on stream around the world. Significant initiatives include Germany's Climate Protection Act and BaFin ESG Risk Management Guidelines, Phase 4 of the EU Emissions Trading System, India's Personal Data Protection Bill, and Vietnam's Revision Law on Environmental Protection. In the face of this wave of regulatory activity, organizations need to ensure they are clear about their regulatory footprints, taking into account their business and operating models across jurisdictions. The best approach will be based on a systematic assessment, which will minimize the risk of regulatory lapses, either in identification of relevant rules or their implementation.

FIVE-STEP PROCESS

Regulatory **screening** and **monitoring** can usefully be implemented:

1 **Identification**
An essential precondition of effective compliance is to centrally identify, through legal and other resources, relevant and upcoming ESG rules, standards, and best practice in the jurisdictions in which the company and its subsidiaries operate.

2 **Prioritization**
Companies must develop a perspective on the applicability of regulation to their specific activities, taking into account the maturity of requirements and their potential evolutions. These can then be fed into an overarching perspective on prioritization needs.

3 **Responsibility**
Companies must decide who should be responsible for interpretation and implementation of individual regulations.

4 **Interpretation**
The responsible person should drill down into the individual regulatory requirements, analyze how they translate to the company's unique context, and identify appropriate implementation plans.

5 **Implementation**
Companies must implement ESG regulatory requirements into their day-to-day operations.

Building an ESG Target Operating Model

Once the factor assessment and regulatory mapping exercise is complete, the company will be ready to build a comprehensive ESG & climate compliance target operating model. (See Figure 3). The model will enable decision makers to both manage ESG matters and ensure there are no gaps in coverage. An effective model may also create value, for example through exposure of business opportunities in a consumer landscape increasingly being shaped by ESG sensibilities.

Our work assessing corporate compliance capabilities suggests that an optimized target operating model would comprise five key elements:

Strategy: Define your north star
What is the importance of ESG for your company and what role should it play within the industry? Business leaders should define their ambition levels, supported by targets for relevant ESG factors and underlying regulatory footprints. These will generate a high-level perspective and form the foundations of a holistic ESG & climate compliance program.

Governance and organization: Set up for ESG success
What is the right organizational setup to ensure impactful outcomes while minimizing complexity? Decision makers should embed ESG topics into organizational structures. The approach should be wide-ranging, taking in decision making, escalation processes, committees, legal entity management structures, as well as role and mandate definitions.

ESG Steering: Define your ESG ambitions
How do you steer against ESG ambitions to mitigate risks and optimize ESG impact (and thereby optimize your ESG rating)? Leaders should put in place comprehensive mechanisms to allow for effective ESG steering, including relating to regulatory requirements, controls, reporting, and risk management.

Enablers: Making ESG happen
What are the enabling factors that can help your company succeed in ESG? Enablers of successful compliance include a deep-seated cultural awareness, alongside the necessary data and analytics skills, technology, and ecosystems.

ESG Products and Services: Create business opportunities
What ESG products and services can your company offer to generate business value? A highly developed ESG organization is likely to catalyze business opportunities that reflect rising consumer, regulatory, and investor demand.

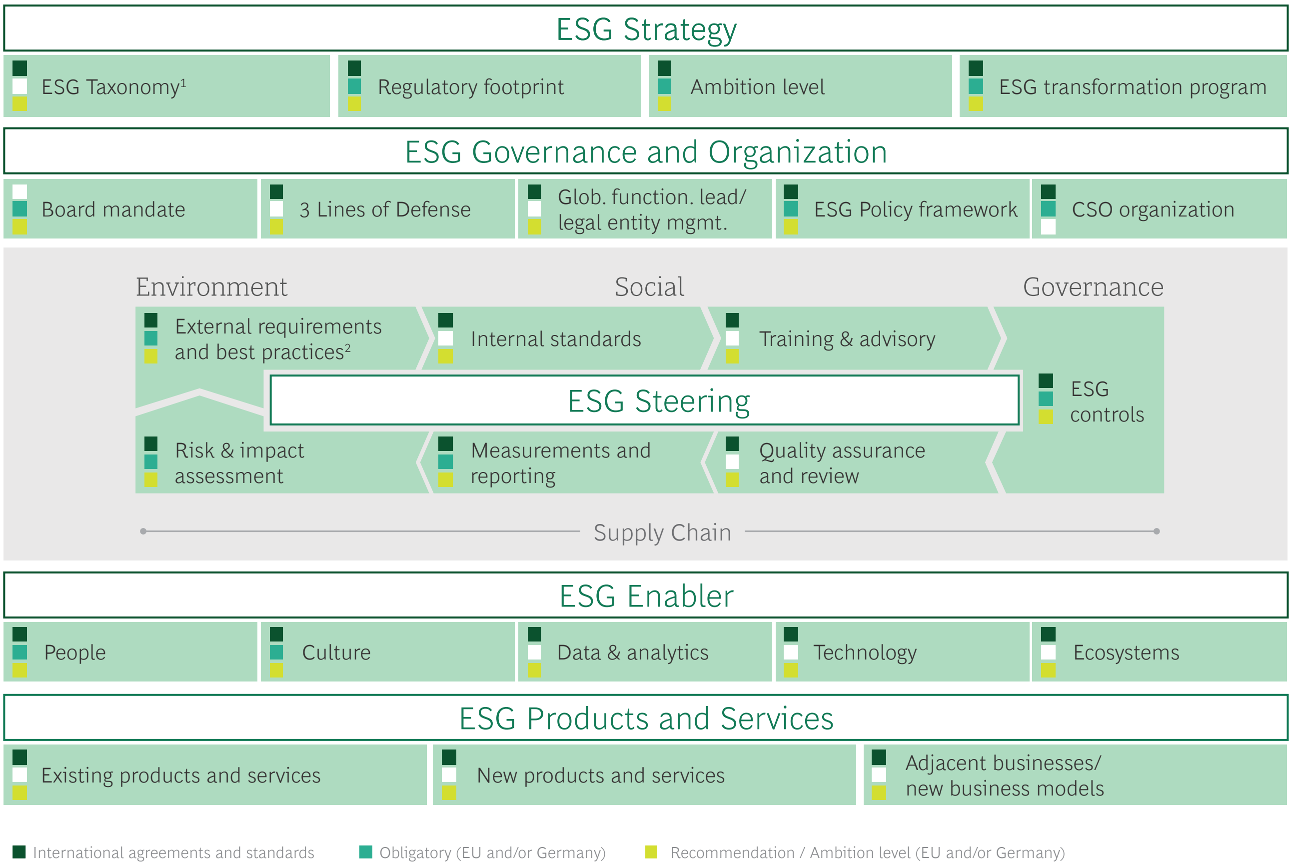


Figure 3: An ESG & climate compliance target operating model

1. And subsequent materiality assessment of ESG taxonomy with regards to materiality along business and operating model
2. Incl. regulatory requirements, rating requirements and stakeholder requirements Source: BCG

Two of the important elements of the target operating model are the implementation of controls, a subset of the ESG steering function, and reporting to senior management and external stakeholders, which will provide the data and analysis to enable effective oversight and decision making. We deep dive into both below.

Deep Dive: Implementing ESG Controls

At many companies, control frameworks have expanded haphazardly over time, as regulatory and business requirements have evolved. Companies, for example, have acted to boost female representation at board level, or have set targets to reduce their emissions footprints, but tend to lack a coherent approach to these kinds of ambitions. As a result, they have accumulated controls, leading to overlaps, redundancies, and blind spots, all of which undermine effective steering.

Systematic ESG & climate compliance risk management should be predicated on a carefully curated set of controls – comprising both a catalogue of existing approaches and new control objectives to address blind spots. To ensure comprehensiveness, we suggest creating a control catalogue, detailing the various processes and facilitating a holistic view of the state of play. (See Figure 4). It also makes sense to centralize responsibility, so that a single person or function (usually the Chief Sustainability Officer) oversees the process. That person will be responsible for developing and maintaining the inventory, as well as reviewing controls, and reporting.

ESG Factors (Level 1)	ESG Factors (Level 2)	ESG Control Objectives
 Environment	Resource consumption	• Ensure efficient **energy consumption** • Ensure sustainable **energy mix** • Ensure efficient **water consumption** • Ensure efficient **material consumption** • Establish **ESG policy** for efficient resource consumption • Establish **risk and impact assessment** (baselining) with regards to resource consumption • Establish **performance measurement** and reporting of resource consumption • Establish **ESG Board mandate and team** to manage resource consumption • Establish **ESG training and awareness** measures for efficient resource consumption • ...
 Social	Community	• Promote social **responsibility in the value chain** • Conduct **human rights due diligence** • Ensure access to **essential services** • Promote **community education** and preserve community culture • Support **public health** development within community • ...
 Governance	Corporate governance	• Ensure independent **internal audit** function to provide oversight of ESG risk management • Ensure **Supervisory board** oversees and advises the Management board in ESG-related decisions • Ensure **adequate composition** of the Supervisory board and Management boards • Ensure independent and qualified annual **external audit** • ...

Figure 4: Controls relate to a variety of ESG factors

Deep Dive: Reporting to Executives and Stakeholders

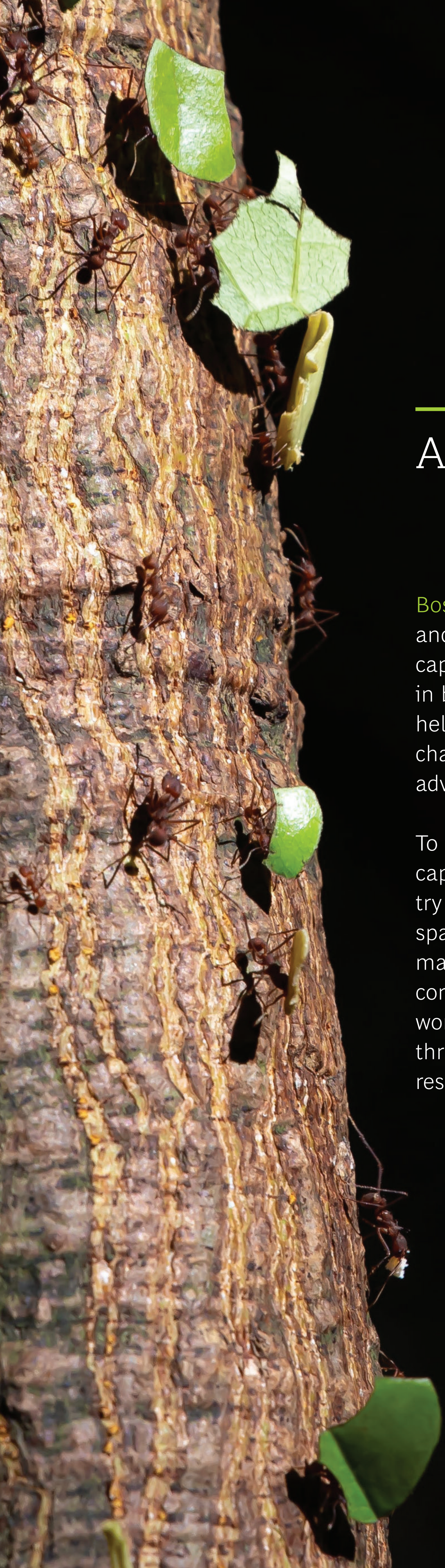
Ratings agencies, regulators, and private entities have launched several initiatives in recent years to support investors and other stakeholders in the measurement and evaluation of ESG performance. Indeed, there are a plethora of ratings, data resources, and sustainability reports that may help inform opinion. Many also serve a useful purpose in helping companies define their exposure to ESG risks. However, their abundance can be a recipe for uncertainty.

To simplify ESG & climate compliance, it makes sense to rationalize resources. By discarding marginal metrics and focusing on a core set of 10 to 15 KPIs and KRIs, decision makers can create more transparency around the ESG factors that are important to them. Of course, the metrics must also align with external reporting requirements, meaning the rationalization must take into account the needs of a broad cohort of stakeholders.

One tool to enable more effective oversight is an “ESG cockpit”, which would detail various KPIs and KRIs, and provide decision makers with a bird’s eye view of risks and compliance profiles. The cockpit would condense the key components of the company’s ESG status, and detail remediation measures in close-to-real time. In so doing, it would equip senior managers with the information they need to ensure the company is performing as close to optimally as it can.

Conclusion

In conclusion, as companies reset in the wake of the COVID pandemic, there is an opportunity to take ESG & climate compliance to the next level. To get there, we recommend a systematic approach encompassing three essential steps. First, an ESG factor and materiality assessment is necessary to identify the ESG themes most likely to have an impact on the business. Next, efforts must be made to create a clear view of the company's regulatory footprint, taking in all of its international exposures. Once these foundations in place, decision makers should oversee the construction of a dedicated ESG & climate compliance target operating model. Through these actions, businesses can equip themselves to manage ESG effectively, ensure there are no gaps in coverage, and meet the increasingly urgent needs of customers, regulators, and investors.



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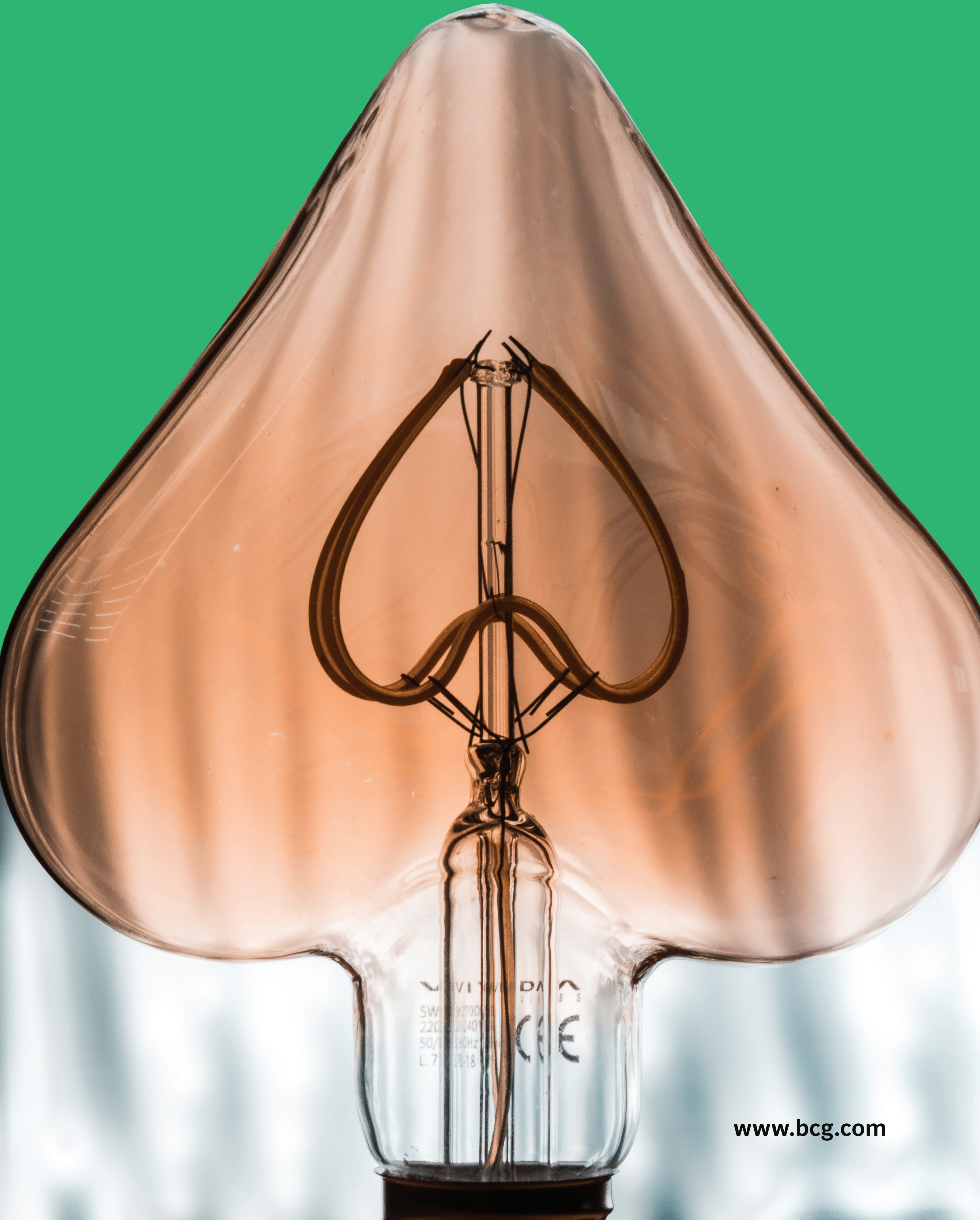

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