ESG Compliance by Design

August 2022

Introduction

The financial and asset management industries have seen a significant rise of the Environmental, Social and Governance ("ESG") focus in their operations, especially since the Paris Agreement was adopted in 2015. The pressure and scrutiny are increasing from both the regulators and consumers to offer sustainable suites of products, and more broadly to meet the UN's Sustainable Development Goals ("SDGs") and global emissions targets set up at COP26 in 2021.

Sustainable finance refers to the practice of taking ESG considerations and objectives into account in the investment process[1]. In financial services, this mainly consists in proposing green finance products, such as green bonds or mortgages and sustainability-linked loans to incentivise sustainable initiatives or reduce environmental and societal impact through financing decisions. As these products become increasingly popular, designing and assuring ESG compliant products is key to prevent reputational damage due to greenwashing.

In Ireland, CEOs expect that the ESG agenda will have an impact on their lending and business decisions in 2022 but few firms see themselves as ready to manage ESG external requirements[2]. In a context of heightened regulatory expectations, led by the growing focus from the Central Bank of Ireland ("CBI") on ESG issues, the need for transparent and robust reporting applied and monitored throughout the product's lifecycle is critical for consumer and market trust.

> The first half of 2021 saw assets under management for ESG funds and outstanding sustainable debt instruments in Europe continue to increase
>
> **CBI, Securities Market Risk Outlook Report, February 2022.**

[1] **Source:** European Commission – Overview of sustainable finance

[2] **Source:** KPMG Ireland Survey, 2021: Global Banking CEO Outlook (assets.kpmg)

> The Central Bank will be focused on ensuring compliance with climate and wider ESG related statutory and regulatory regulations and on effective climate risk mitigation. We must ensure the orderly functioning of markets and wider market integrity, particularly in the development of sustainable finance and the prevention of 'greenwashing'.
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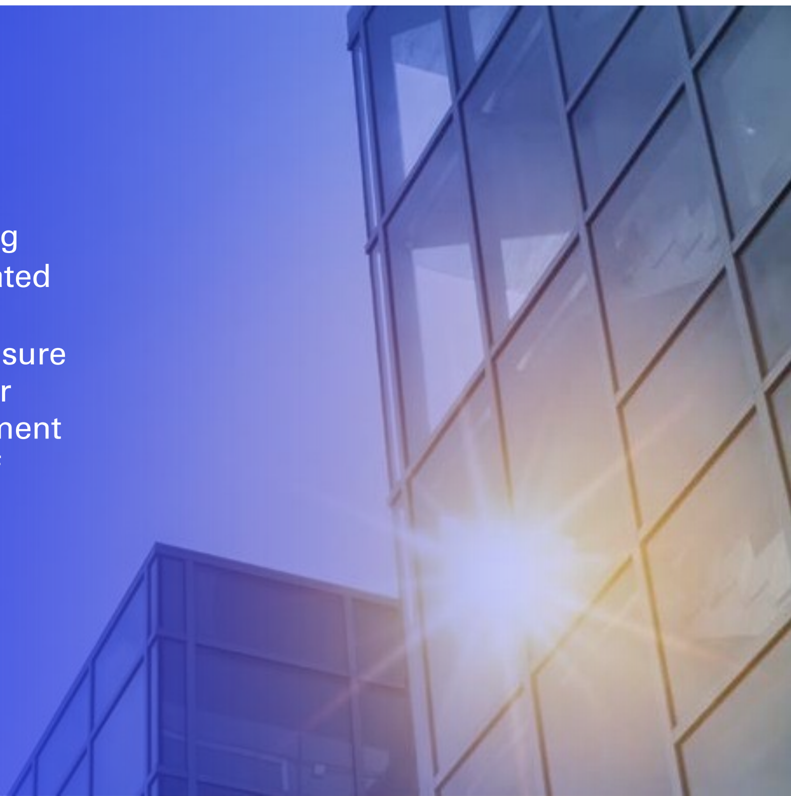
> **CBI, "Dear CEO" Letter, November 2021.**



Designing and Assuring ESG Compliant Products

The volume of green and sustainable lending has risen dramatically in 2021 with European ESG bond and loan issuance of €498.9bn in Q3 2021, already surpassing the total amount issued in 2020 of €388.7bn [3] and with figures expected to increase over the coming years. While offering ESG related products has become a source of competitive advantage for firms, the sudden demand for these products may result in reputational damage and exposure to litigation in cases where potential product flaws were not identified at the design stage.

Firms need to be able to market ESG products that are **compliant by design**. This approach allows companies to embed assurance testing procedures into products at the design stage to identify potential exposure to reputational damage from launch and throughout the entire product lifecycle. For more information, please visit our website: Compliance by Design - KPMG Ireland (home.kpmg)

Designing ESG compliant products is driven by the below challenges and behaviours:

- With the growth of ESG products on the market, practices such as **greenwashing, mis-selling or misrepresentation of investment strategies** are becoming more common. Greenwashing refers to practices whereby firms make unsubstantiated claims that a financial product is environmentally friendly. These practices are causing reputational damage due to the lack of transparency of sustainable products. This can be addressed by designing compliant products and monitoring their operation at all stages of the product lifecycle to ultimately reduce exposure to reputational damage with a clear and suitable product offering;

- **Product suitability** is an important consideration for firms. The European Commission has adopted a number of Directives, such as the Markets in Financial Instruments Directive ("MiFID") and the Insurance Distribution Directive ("IDD") which require investment firms and insurance distributors to offer suitable products to meet their clients' needs. In line with the Consumer Protection Code ("CPC"), firms need to ensure that consumers' sustainability preferences are sufficiently considered when recommending products. Firms need to understand their consumers' ESG preferences at the outset of the customer journey; and

- **Sustainable consumer behaviours** are emerging as consumers become more aware of climate change or social justice issues and their individual impact on these areas. This is additionally enhanced by increasing government pressure on consumers to make sustainable purchases (e.g. environmental warnings, carbon reduction targets). In that context, firms are pressured to comply with regulations by converting or diversifying their product offering.

  Implementing a strategy that takes product compliance into account at the design phase demonstrates a proactive and preventive strategy to reputational risk. Once target ESG outcomes have been defined, adequate monitoring and reporting can be integrated into the overall design of the product.

[3] **Source:** AFME, Q3 2021: ESG Finance Report

Sustainable Reporting Transparency

Consumers can find it difficult to compare sustainable products and how these contribute to environmental objectives. The lack of clear taxonomy and standardised reporting requirements can discourage consumers to invest in ESG products. Some considerations in respect to transparency and reporting are summarised below:

- With raising concerns about transparency due to greenwashing practices and the general increase of ESG products in the market, firms need to improve the **reliability and the quality of their data** ensuring consistent information and reporting. This can be addressed by designing fully compliant products and assessing the end-to-end product lifecycle to detect potential exposure to reputational damage and develop the necessary data strategy that supports ongoing monitoring;

- Several features need to be considered when designing ESG products, such as the way to measure the products' progress towards its original sustainable objective or the diversity of existing products and metrics. This should feed into a **consistent reporting strategy** for the products and help contribute to the long-term sustainability preferences of consumers and the ESG market by producing transparent information and ensuring that easier comparison data is available; and

- On top of product design, implementing strong governance practices is key to improving transparency and ensuring that consumers can make more informed and responsible investment decisions. **Embedding long-term sustainability objectives into corporate strategies** and adapting existing processes and products will help reduce risks and potential consumer detriment.

The ESG reporting requirements have faced multiple challenges from the absence of consistent data measurement and disclosure to poor standards not leading to accurate performance comparison across businesses. The necessity for transparent ESG data is entering a new phase strongly led by governments and regulatory bodies.

Regulatory Landscape and Expectations

The ESG regulatory landscape is now shifting rapidly to reach harmonisation in reporting and disclosure standards. The following regulations set the new challenges for firms engaging in ESG products offering:

- **Delegated Acts**
  With origins in both the Paris Agreement and ensuing EU Action Plan, the Delegated Acts call for UCITS and AIFMD to take **sustainability risks** into account in organisational procedures, resources, the management of conflicts of interest and risk management policies, in addition to considering sustainability risks and factors when undertaking investment due diligence.

- **Supervisory Expectations**
  The CBI has set out its supervisory approach to climate and ESG issues for the attention of Irish financial service providers in November 2021 and is focussing on areas such as governance, implementation of risk management frameworks and disclosures. While noting that these expectations are not prescriptive, the attention is brought on risk identification, measurement and monitoring as well as on the importance of transparency for consumers. The CBI has made it clear that ESG and climate issues will be a key component of its global agenda and that these will be discussed in relation to all markets. As such, in February 2022, the CBI has addressed sustainable finance issues in the Securities Risk Outlook Report urging firms to promote leadership and a culture of compliance with how they treat sustainability matters;

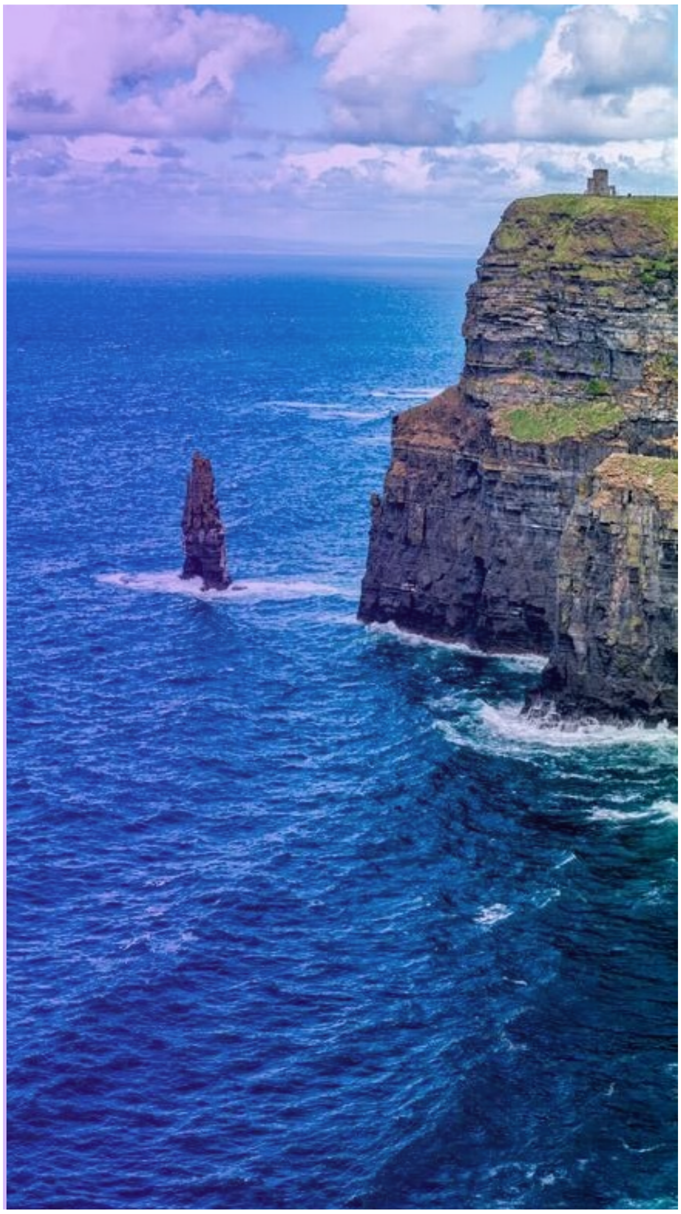
- **Disclosure Requirements**
  The Delegated Acts do not address the disclosure of sustainability risk by UCITS managers and AIFMs; these requirements are set out under Sustainable Finance Disclosure Regulation ("SFDR") and in the Taxonomy Regulation.

  The **SFDR** requires asset managers to provide prescript and standardised disclosures on how ESG factors are integrated at both an entity and product level. A significant portion of the SFDR applies to all asset managers, whether or not they have an express ESG or sustainability focus. The SFDR manifests in additional disclosures for financial market participants on websites, in prospectuses and in periodic reports.

> "Capital markets, through lending and investment flows, have a central role to play in the transition toward a carbon neutral economy. The Central Bank will continue to play its part in addressing climate risks and the transition to a carbon neutral economy as a strategic priority.
>
> **CBI, Securities Market Risk Outlook Report, February 2022.**

The **EU Taxonomy** is a new type of classification system which provides a list of environmentally sustainable economic activities. The Taxonomy will require financial market participants and companies to disclose their climate change mitigation and adaptation performance in a comparable way by the start of 2022 and broader environmental objectives by January 2023. The CBI will monitor the application of the EU Taxonomy for activities regulated in Ireland.

Conversely, the proposed **Corporate Sustainability Reporting Directive** ("CSRD") aims to improve reporting by corporate entities and ensure the availability of information regarding the risks caused by sustainability issues. It is anticipated that the Directive will come into effect in 1 January 2024, with companies reporting in 2025. The changes involved are expected to strengthen sustainability reporting in the EU over the coming years, especially due to the additional categories of companies required to comply to the Directive.



Delegated Acts 'Go Live'

1 August 2022
Application date of the UCITS / AIFMD Delegated Acts requiring the integration of sustainability risks in the organisational procedures, the management of conflicts of interest and risk management policies in addition to considering sustainability risks and factors when undertaking investment due dilligence

2 August 2022
Application date of sustainability related provisions under MiFID and IDD delegated acts

22 November 2022
Application date of MiFID product governance measures requiring consideration of sustainability factors in product governance, approval and oversight

1 December 2022
Member States to bring into force measures necessary to comply with Articles 1 to 3 of CSRD (TBC)

30 December 2022
Article 7 SFDR disclosures on product level PAI consideration applies

1 January 2023
- Application date of SFDR RTS
- Provisions in Article 1-3 CSRD to apply for financial years starting on or after 1 January 2023 (TBC)
- Non-financial undertakings start disclosure full KPIs on taxonomy alignment under Article 3 Taxonomy Regulation delegated act

How can KPMG help?

KPMG's Risk Consulting experts have extended experience in conduct, regulatory and financial services sectors. KPMG provide risk and regulatory advice, proposition design, operational risk and control optimisation services. We partner with our Sustainable Futures experts to ensure that you have appropriate frameworks in place to meet regulatory expectations and ensure that sustainability risks are managed and controlled to avoid exposure to reputational damage and weak market stability due to inappropriate actions and practices. Examples where our team can assist within each of the regulatory landscape are as follows:

1. Governance

- We can support you in designing and implementing a bespoke product assurance approach to control your product set and align with the evolving and expanding product governance and consumer protection expectations; and
- We can also assist you in developing and refining governance structures (and related Management Information) to support proactive and effective decision making.

2. Product Design

- We can assist you in reviewing existing product design policies and ensure that the consideration of sustainability risks are evidenced at each stage of the product design process; and
- We can support you in implementing a step-by-step Product Simplification process that identifies, measures and realises benefits with a consumer, regulatory and operational lens. For more information, please visit our website: Product Simplification - Reducing product risk - KPMG Ireland (home.kpmg)

3. Risk Management Framework

- We can help you in designing, assessing, and embedding the impact of climate change on your risk profile; and
- We can assist you to implement internal control mechanisms to ensure product suitability at each step of the product lifecycle ensuring that the Board has adequate MI and risk reporting to inform discussion and decision-making.

4. Disclosures and transparency

- We can assist you with gap analysis and assessment of any updates of fund prospectuses against regulatory requirements for Article 6 Funds; and
- Additionally we can assist with Article 8 and 9 funds through gap analysis and assessment of the SFDR Information card.

Contact us

Gillian Kelly
Partner & Head of Conduct Risk Services
Risk Consulting
t: +353 87 744 1120
e: gillian.kelly@kpmg.ie

Jorge Revilla
Partner
FS Audit
t: + 353 87 744 2776
e: jorge.revilla@kpmg.ie

Shane Garahy
Director
Risk Consulting
t: +353 87 050 4848
e: shane.garahy@kpmg.ie

Bianca Maudet
Manager
Risk Consulting
t: +353 87 050 4694
e: bianca.maudet@kpmg.ie

Russell Smyth
Partner & Head of Sustainable Futures
Sustainable Futures
t: +44 773 860 3869
e: russell.smyth@kpmg.ie

Sarah Moran
Director Sustainable Futures & Climate Risk
Sustainable Futures
t: +353 87 050 4085
e: sarah.moran@kpmg.ie

kpmg.ie

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