ESG Heartbeat

Assessing the steady progress of the financial services sector

A KPMG report
Spring 2023

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Foreward

ESG Heartbeat is a snapshot of the progress that financial services firms are making in addressing the environmental, social and governance (ESG) imperative. We know, from our own regular conversations with clients, that ESG is a priority concern for the vast majority of financial services firms – and that many see both risk and opportunity. We also know that many firms are struggling to wrap their arms around the challenge. In this research, we aim to identify common concerns and to suggest positive ways to overcome them.

Our research is based on a variety of sources. It includes data from a KPMG survey of financial services firms themselves, providing both qualitative and quantitative findings. We have augmented this with information drawn from public disclosures made by financial services firms in banking, insurance and wealth and asset management. We have also drawn on insights generated by our own client engagements.

The result is a comprehensive assessment of ESG progress across the financial services industry, charting both those areas where firms are advanced and where there is more work still to do. Our research also includes perspectives from on the ground, supplied by KPMG's own subject matter experts.

We look forward to discussing the findings with you – and moving forward together on the ESG journey.

Noeleen Cowley
Head of Financial Services Consulting
KPMG in the UK

Richard Andrews
Head of ESG
KPMG in the UK

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State of the Nation

A KPMG perspective on ESG progress being made across financial services sectors including banking, insurance, wealth and asset management and private equity.

ESG in banking

Richard Bernau

Global Banking ESG Lead

KPMG International

Begoña Ramos

Banking ESG Lead

KPMG in the UK

"Across our banking clients, there is a wide range of ESG-driven action. I see everything from ambivalence to a genuine desire to embrace the change. Yes, it varies from firm to firm and from region to region. It is well known that regulation has been a key driver of action and that means that in some countries where policy has been swift, firms have had the benefit of a head start. But for those markets and for firms that might have been late to start, there is a clear path for catching up. It's now possible to learn from the leaders by seeing what has worked well and avoiding the mistakes and false starts. At the individual firm level, I still see a distressing number of firms who feel that minimum compliance is an acceptable strategy. This may be just a part of their ESG journey, but it feels like an acceleration is imminent.

I am heartened that when our banking clients scratch beneath the surface, they start to see there is great opportunity. The need to fund the transition is without a doubt the largest financing opportunity of our lifetime. Being prepared for that is a not just an exercise in compliance. The most advanced banks that I work with are seeing that they need to embark on a front to back transformation. It starts at the top with culture and training and moves through to structure, governance, products and processes. All aimed at understanding and supporting the ESG journeys of their clients. This is how they will capture the opportunity as well as avoiding risks to reputation and of being left with stranded assets.

The role of banks is changing. This is uncomfortable, moving from a reactive business model to an engaged and forward-looking business model. The pace of change is fast – things that look impossible today, have a habit of becoming inevitable tomorrow. I am encouraged that many of our banking clients understand this. To the rest, I would simply say, don't get left behind."

ESG in private equity

James Holley

Private Equity ESG Lead

KPMG in the UK

"For the private equity (PE) sector, ESG issues and concerns are increasingly viewed through the prism of value. ESG shortcomings can potentially erode value; a strong ESG story, by contrast, can drive a more rewarding exit.

On this basis, **many PE firms are working hard to align their ESG strategies to the process of value creation**, both at a firm level and within their portfolios. They recognise that value is at risk if drivers such as climate change are not integral to investment strategy. ESG is becoming more of a central consideration during due diligence processes.

More fundamentally, there is also the potential to embrace ESG as an exciting business opportunity: innovative PE-backed businesses will play a key role in confronting many of the challenges the world currently faces."

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ESG in wealth and asset management

Daniel Barry
Wealth and Asset Management ESG Lead
KPMG in the UK

"Following a year which saw society having to grapple with issues generally taken for granted, not least national security and energy security in the wake of the Russian invasion of Ukraine, it is not the least surprising that ESG came under sustained attack. **The questioning of ESG is not the sound of its death knell as hoped by its detractors but rather an opportunity to elevate our thinking** around its principles and goals and to consider how to bring it into the mainstream in light of the economic trade-offs we have to face.

Mainstream asset managers considering their fiduciary duties have, for the most part, concluded that integrating ESG into their investment decision making process enhances their understanding of risk and return. Within that group, some firms are going further to consider how their investments impact social and environmental objectives – what is referred to as "double materiality" – to deliver on mandates from large institutional asset owners who have committed themselves to sustainability.

Fortunately, while political debate rages on in the press, asset managers are getting on with the job, delivering results to their clients who have both financial and ESG expectations.

However, we are witnessing a significant shift as leading asset managers are beginning to realise blending scalable and reliable outsourced solutions for ESG is no longer adequate. The need to transform to bring ownership of resources and expertise in-house and to more closely safeguard their ESG practices as firms suffer reputational loss from greenwashing allegations they didn't protect against.

This transformation is the opportunity for firms to meet evolving client expectations and to deliver a service that is authentic in an industry that is still grappling with partially embedding ESG."

ESG in insurance

Roger Jackson
Global Insurance ESG Lead
KPMG in the UK

"Across our insurance clients the ESG regulatory, accounting and political space has continued to move at pace, presenting the insurance C-Suite with a huge array of challenges from non-financial reporting to greenwashing at a time of increasing budgetary constraint, at the same time as trying to understand and getting ready to respond to the commercial opportunities that inevitably will arise from transition.

Quite rightly there continues to be substantial focus on non-financial reporting, as disclosure requirements continue to expand both in terms of topic areas (e.g. nature and social) and globally, which is providing a challenge for global groups to navigate. The greater focus being placed on these disclosures is driving firms to look at their ESG data and technology stack to ensure robustness of delivery and underlying controls. Data is particularly critical for baselining GHG emissions and in turn setting realistic targets. Increasingly this is an area which is becoming highly political given its potential impact on insurance coverage, as the reality of the huge difficulties in effecting a smooth transition become ever more evident.

At the same time, the ESG agenda is increasingly influencing stakeholder expectations. Customers want to understand the ESG credentials of their insurers and on the asset management side investors are increasingly factoring in ESG considerations when making investment decisions. In addition, a more purpose-driven workforce want to work for insurers that are proactive on the ESG agenda. Hence, ESG now plays a key role in how insurers manage their customer relationships, employee experience and supply chain partners.

In short, ESG is not going away, and is increasingly seen as a key business imperative, not a nice to have."

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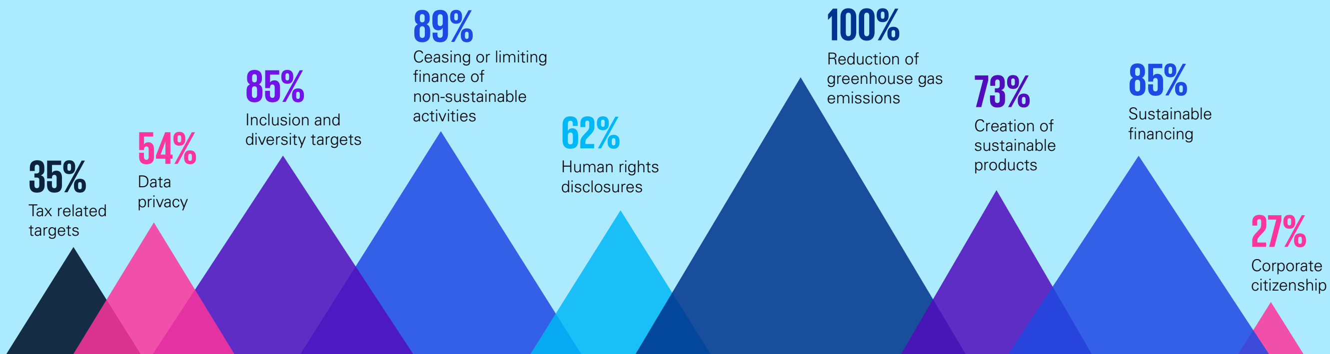
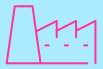
Steady as she goes

Despite 2022 looking like it would be a challenging year with other priorities perhaps overtaking ESG, we continue to see strong momentum across the financial services landscape.

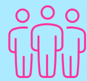
Figure 1: ESG targets set by organisations in 2022



Of the 27 participants in the survey, 26 responded to this question - including 10 banks, 10 insurers and 5 asset/ wealth managers.



Emission reduction remains a key priority across business operations and financing portfolios



Social priorities in ESG strategy include human rights and inclusion, diversity and equality (IDE)

Other governance issues including tax and data privacy are also reasons for organisations to set targets

Source: KPMG LLP, 2023.

The financial services industry's commitment to environmental, social and governance (ESG) issues might have been expected to falter in the current climate. The economic headwinds buffeting the sector are forcing firms to focus on other priorities. Market volatility, high inflation and the threat of recession have been constant distractions. And in certain key markets, a backlash against the "woke" ESG agenda has given the industry some pause for thought.

However, the evidence of KPMG's latest research is that the embrace of ESG is continuing. Twenty-seven large institutions took part in the research – in most cases, UK-headquartered businesses with global footprints – spanning sectors including banking, asset and wealth management and insurance. Their message is consistent: pursuing the ESG agenda remains a critical business priority.

There are good reasons for this. A broad range of stakeholder groups – customers, employees, shareholders, regulators, policy makers and more – are pressing the sector to go further. There is also a body of evidence (public and financial discoursers) that businesses with stronger performance on ESG criteria may deliver superior financial returns; **our clients are telling us that attention to ESG can certainly be value-additive.**

All respondents published a publicly available ESG strategy and receive board sign off on their ESG strategy. Climate change is cited as a significant risk to their organisation and ESG data availability, accuracy and comparability remains a key challenge.

"Almost without exception, every financial services firm we talk to wants to discuss ESG. Whether its related to compliance and risk management or whether its an ambition to grow new business areas - its always on the agenda. At KPMG, we are committed to ESG in our own business, but more importantly, we are committed to supporting our financial services clients on their ESG journeys. And we are still only at the beginning of those journeys. Reaching net-zero targets and fulfilling UN Sustainable Development Goals, are examples of where the journey may end. We remain positive, because everyday we see movement in the right direction. I am confident in our new ESG global hub to be prepared to bring the best of KPMG to all of our clients"

Francisco Uria Fernandez
Partner, Global Head of Banking
KPMG International

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90% said “positive correlation between ESG factors and returns” was a driver of ESG integration

60% answered regulatory requirements, making it the least voted reason for ESG integration

Figure 2: Drivers of ESG integration

Source: KPMG LLP, 2023.

Despite the obvious expense and considerable complication, financial services clients continue to see commercial benefits in orienting their business models towards ESG. In conversations and in whispers across the marketplace, we often hear of clients concerned that ESG is all about compliance and unnecessary new processes. The truth is more complex. Our clients see that they can create stronger returns while decreasing the risks in their businesses. Yes, regulation is still a strong driver of business model change, but so too is pressure from stakeholders.

The banks within our survey told us that they see strong commercial opportunities arising in the next 3-5 years in individual ESG linked loans, financing linked to ESG criteria and in ESG saving and investment products. The wealth and asset management firms told us they see commercial opportunities in impact investing and stewardship activities. The insurance firms told us they see commercial opportunities in climate risk advisory, insuring ESG assets and in impact investing.

Finding new business opportunities in crowded, competitive markets with intense regulatory pressure is challenging. Our clients are telling us that ESG is an area where they can grow their businesses.

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Evidence builds showing ESG investments offer better returns

Richard Bernau
Global Banking ESG Lead
KPMG International

Begoña Ramos
Banking ESG Lead
KPMG in the UK

"We are seeing a new wave of commentary and research that proposes a subtly different narrative for the case for ESG investment over the medium to long-term. This draws on two arguments. The first argument is that there is a high correlation between ESG-focused companies and well-run companies. The second is that an ESG-focused company is more resilient as its wider view and understanding of risk is likely to leave it better prepared for a wide spectrum of possible risk scenarios.

For some time now there has been a narrative that ESG-oriented portfolios have outperformed conventional portfolios. This narrative has been used by proponents of ESG to make a financial case for ESG – in addition to non-financial reasons that an ESG portfolio might be attractive such as beneficial environmental or social outcomes. However, many ESG products sold to the market have been little more than "closet tracker" funds (that is, matching the performance of the S&P500 or similar large indices) promoting their ESG profile by excluding some of the worst emitting companies or tilting towards tech or service stocks with small environmental footprints.

During the COVID-19 pandemic in particular, these ESG funds outperformed the market for a number of reasons. One of the major drivers was sector allocation: their overweighting of technology and underweighting in oil and gas drove performance as tech valuations soared and the price of oil on international markets sunk to $20 per barrel. However, there was also significant momentum in ESG-related stocks: tech names (including profitless companies caught up in the SPAC boom) catering to the "new economy" as people in lockdown turned to tech and media for work and entertainment, they saw demand for their goods and services accelerate. In brief, ESG outperformance has been broken down into fundamental factors with academic literature questioning whether "ESG alpha" exists at all – seriously undermining the financial case.

These theories may need more time and data for real world validation. It may yet turn out that observation of higher performance are reflections of other fundamental factors, but we are certainly seeing a trend amongst our clients to associate higher returns with ESG investments. The prime example of this is that we see many private market investors now fully embracing ESG within their value creation processes. When some of the most cynical and hard-nosed investors in the market are making ESG an integral part of their investment process, then that is a strong indication that the rest of the market needs to catch up."

ESG progress still faces significant challenges

Nevertheless, the question marks remain. Are financial services organisations genuinely moving forward, with a commitment to ESG that is deeply embedded, or is their embrace at surface-level only?

Certainly, the sector faces some difficult challenges. The breadth of ESG regulation is difficult to deal with, particularly as it is evolving at different speeds – and in different forms – in jurisdictions around the world. The ability to react also differs around the world, with businesses in some regions struggling to march to the pace of the drum beat of others.

While our clients believe that there are greater returns to found within ESG, they also understand that challenges remain. The challenge referred to most often is ESG data.

Financial services businesses are struggling to collect the ESG data they need to deliver on their commitments – often, this data simply does not exist in an accessible format. The lack of a clear and consistent lead from policymakers adds to complexity. And societal attitudes are constantly on the move. We will be considering ESG data in more detail in section 5.

Our research indicates that fixed income and equity investors agree the top three data challenges are:

- data coverage / availability
- data accuracy
- data compatibility

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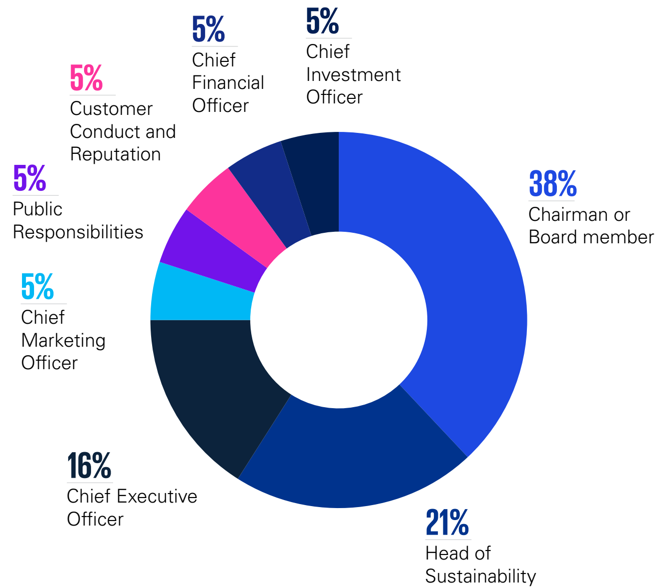
Closing in on greater maturity

Governance emerges as a cornerstone to ESG maturity

Financial services organisations continue to make strong progress on the groundwork of their ESG engagement, publicly committing to clear agendas and building governance structures to deliver on these pledges. The challenge now is to back words with action – to operationalise the ESG strategy throughout the organisation. While such work will be less visible outside the organisation, this is how financial services businesses will deliver on the commitments and pledges they are making. Their tasks are to embrace ESG proactively and to embed ESG management processes end to end throughout key functions of the organisation.

Rethinking governance is an important part of this process. Many organisations are continually thinking about how they embed ESG in everything they do, rather than considering it as a standalone activity. The launch of new ESG committees and centres of excellence continues to grab attention, particularly when focused on issues like ESG data. Many financial services organisations are now considering how they can evolve centralised "crisis" teams towards proactive governance structures that represent the ESG impact on the business and relevant functions.

Figure 3: Who is accountable for ESG



Source: KPMG LLP, 2023.

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ESG governance: the data

Figure 4: Functions that have ESG responsibilities

Source: KPMG LLP, 2023.

Figure 5: Teams that received ESG training

Source: KPMG LLP, 2023.

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The good news is that ESG is slowly making its way through the fabric of the organisation, rather than being dealt with in silos by teams looking at the part of the issue relevant to them. Eventually, corporate social responsibility (CSR) teams may even become a thing of the past. Nevertheless, significant governance challenges remain – ESG is still too often driven by one part of the organisation alone, leading to imbalance and elevated risk.

The way in which ESG is represented differs from organisation to organisation – perhaps as an internal risk, external risk, or both – with many only just starting to recognise the all-encompassing impact of ESG. Too often, one lens dominates the view, preventing a balanced and coherent approach.

The leaders, by contrast, are moving beyond this imbalance and working towards an embedded approach to ESG by seeking the correct representation within the business.

One thing is clear – the agenda is being dictated from the highest level – 100% of boards and executive managements in this research have ESG responsibilities.

There is still a long way to go – while firms are setting out plans for ESG responsibility to trickle down the organisation, not all teams are necessarily equipped to embrace it.

Not least, training is still lacking across functions that have been passed the ESG baton. And while management information is being reported upstream, there is no evidence that this information is being used efficiently, against real performance metrics and to inform strategy on a frequent basis. Indeed, relatively few organisations are setting themselves challenging targets to drive stronger ESG performance, or keeping themselves honest with iterative reviews.

Building ESG capability

Ross Molyneux

Director, Financial Services ESG

KPMG in the UK

"Successfully embedding ESG within an organisation requires fine balance and coordination between its different parts; everyone must understand their functional roles and possess the ability to adapt to external factors.

One of the most significant challenges we see is a rush to build out ESG capability and headcount, and uplift a single function – whether central sustainability, risk or the frontline – delivers an imbalance in organisational structure. This imbalance, generally created by a single function holding greater spans of control and accountability, can result in an agenda driven by the priorities or metrics of the more empowered function. This upsets the need for a balanced trifecta of ESG ambition, risk management and financial returns.

This can have significant ramifications. Communication failures and functions **driving ESG-related activities in a vacuum may create internal frictions and, worse still, unrealistic public commitments.**

We have seen examples of organisations, particularly around net-zero target setting, making statements driven by the sustainability function for which they will be held accountable without engagement or validation by those charged with making them a reality. Similarly, business decisions driven by a more empowered and authoritarian frontline have resulted in challenges to the organisation's ESG commitments, particularly around the types of clients they service and transactions they conduct.

There is real danger in getting this wrong. The failure to create a clearly coordinated and balanced organisational structure for ESG runs a tightrope of risk that could damage the organisation either financially or reputationally. An absence of understanding of both opportunities and risks from ESG-related activities, created by poor coordination across the organisation, may result in sub-optimal decision-making hampering the organisation.

There is the risk of potential reputational damage including greenwashing accusations, as organisations say one thing but appear to do another. While fines and enforcement have been used sparingly to date, recent climate litigation shows that groups such as NGOs are ready to act."

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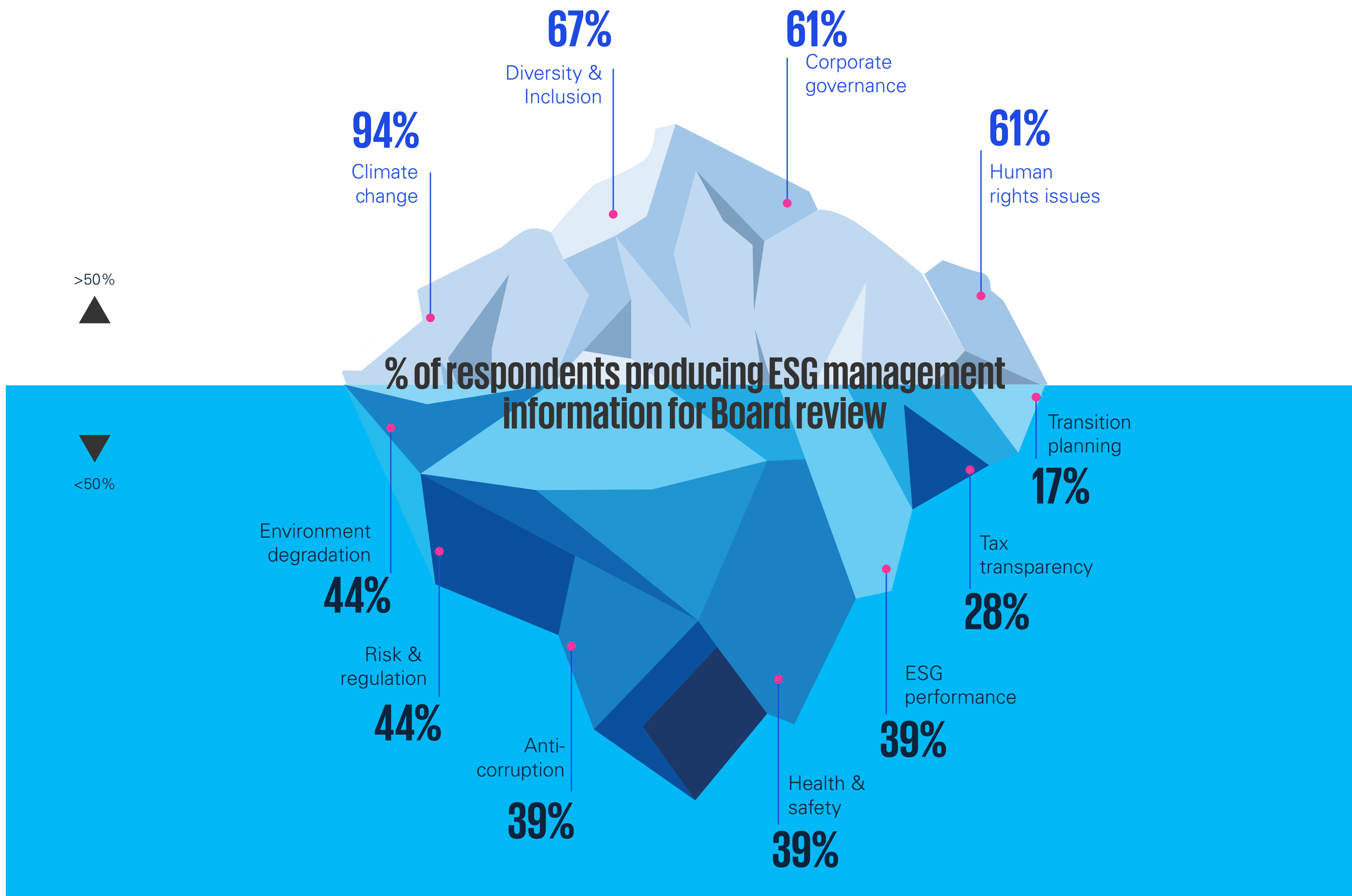
Figure 6: ESG information produced for Board review

"Climate change information is still by far the most common board level information, but other ESG topics are catching up"



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Moving towards ESG maturity

To move towards ESG maturity, organisations must accept that ESG is everyone's responsibility, requiring equal buy-in, weight and seniority across key functions. They need a co-ordinated multi-disciplinary, multi-function ESG taskforce to develop the framework and structure for ESG activities and accountabilities within the organisation. Complementary performance metrics at executive and management level will ensure everyone is moving towards a common goal. The value of an independent voice – internal audit, perhaps, or a non-executive director or external advisor – in securing balance cannot be over-estimated.

Our data shows that financial services organisations are still a long way off achieving this balanced and coordinated approach: ESG is not yet everyone's responsibility, nor is board-level reporting frequent enough and sufficiently covering a range of ESG topics.

Organisations now need to interpret commitments practically. They must build enduring structures that support proactive change through multi-year projects. This is how they will move towards ESG maturity. For now, there is little evidence of an end-to-end, functional approach to managing ESG risk and opportunities at many organisations. Moreover, education and management information reporting for the whole organisation is infrequent and patchy.

ESG Reputation Management

The danger for organisations that fail to accelerate in this regard is tougher scrutiny and reputational harm. In particular, the growing determination of regulators to identify and sanction greenwashing in the financial services industry should be a real wake-up call. The European Securities and Markets Authority (ESMA) is set to launch a new regime to counter greenwashing. In the UK, the Financial Conduct Authority (FCA) is also pursuing new rules, with the Sustainability Disclosure Requirements and investment labelling regime, to strengthen its powers on greenwashing.

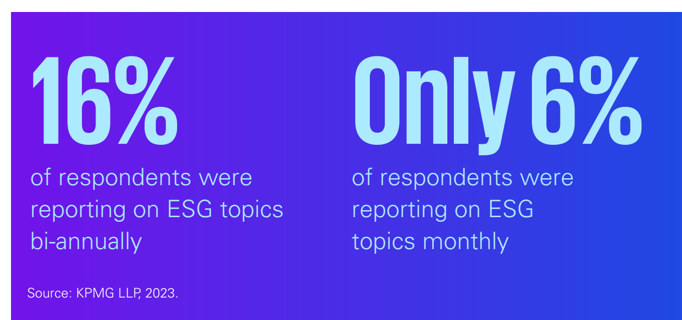

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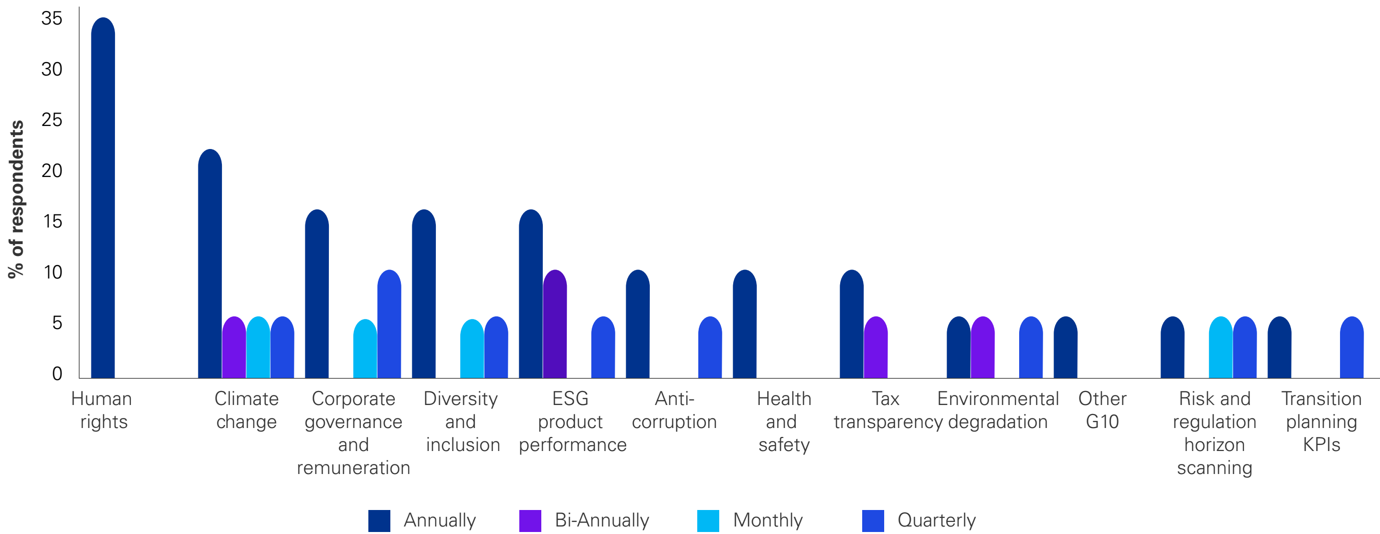
Figure 7: Frequency of ESG reporting by topic

Less than 50% of total respondents confirmed they were reporting on ESG topics frequently. The most reported topic was human rights, with 33% of respondents reporting on this annually.



Source: KPMG LLP, 2023.

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Regulation – is it driving the right actions?

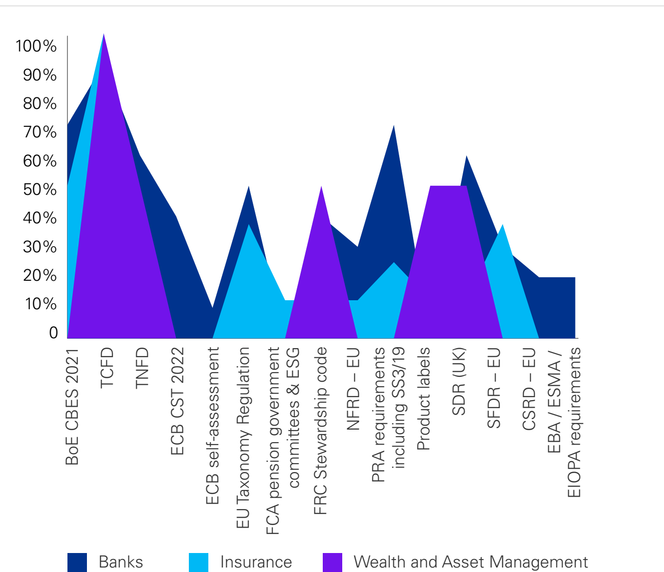
A blizzard of reporting standards

The danger, amid a blizzard of monitoring and reporting standards, is that businesses lose sight of what is really important; their efforts to comply on reporting may prove so overwhelming that they are distracted away from a clear pathway to positive change.

New regulation on ESG issues continues to require significant resource commitment from the financial services sector – particularly in Europe, but in jurisdictions worldwide too. Reporting and disclosure requirements are still evolving – and they frequently remain inconsistent – with many organisations working to align with multiple sets of standards.

Moreover, there is further change to come. In October 2022, the FCA unveiled a series of proposed new rules for sustainability disclosure requirements and investment labels, including a new anti-greenwashing rule. The final version of the rules is due to be published in the coming months. Separately, the FCA is also consulting on how to bring ESG ratings providers into the regulated sphere.

Figure 8: Regulation and compliance standards over the next 3 years



Source: KPMG LLP, 2023.

Finding clarity amid the complexity

Michelle Adcock

Director, Regulatory Insights Services Centre

KPMG in the UK

"It is important to recognise that ESG-related regulation is a relative newcomer to mainstream supervision. The pace of development has been extraordinary in mature markets, underlining its political weight and importance to stakeholders; this was not an area where regulators and standard setters could afford to take their time.

Wealth and asset managers were initially at the sharper end of ESG pressures and were possibly more attuned to the broader sustainability concepts underpinning responsible investment. It took a while for ESG understanding to percolate through to banks and insurers, but once governments took decisive steps to drive capital to sustainability initiatives, regulation really started to gain traction.

Amid this complexity, we need to remember that the process has a purpose. Our most successful clients are the ones that have a clear vision of the opportunities that ESG creates.

We now have a rapidly evolving and increasingly crowded regulatory landscape – the so-called "alphabet soup" of regulations, directives, policy statements, guidance, standards and frameworks.

These range from Task Force on Climate-related Financial Disclosures (TCFD) or taxonomy-aligned disclosures to Pillar 3 ESG reporting, expectations for the monitoring and managing and of climate and environmental risks, entity and product level sustainability disclosures, corporate due diligence, calls for the assurance of carbon credits and moves to ensure the robustness of ESG data and ratings. And the initial focus on climate is expanding fast to nature, biodiversity, the circular economy, social objectives and more in the pursuit of a just transition."

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Managing the regulatory demand

For those firms taking part in this research, the biggest workload currently relates to environmental regulation, specifically climate. The standard to which most organisations are already aligned across sectors is the United Nations' Principles for Responsible Banking and the Principles for Responsible Investment, one of the first standards to promote sustainable investment that includes E, S and G criteria. Our data shows organisations have prioritised aligning to reporting and disclosure standards, and there is still further work to do here. Chosen standards differ across sectors, but the most popular are CDP reporting, (formerly Carbon Disclosure Project, now CDP Worldwide or CDP) TCFD, Sustainability Accounting Standards Board (SASB) and Global Reporting Initiative (GRI).

When looking to reporting that is driving the future, TCFD is leaps ahead with nearly 100% of respondents confirming they will have complied in the next three years. Interestingly, the Task Force for Nature Related Disclosures TNFD is also a priority for banks as well as stress testing. Such demands are driving more far-reaching change. Two-thirds of respondents (67%) say they are now conducting scenario modelling and stress testing that is much broader than the work required by the Prudential Regulation Authority.

Worryingly, upcoming mandatory regulatory requirements such as Corporate Sustainability Reporting Directive (CSRD) and the EU taxonomy are not emphasised by organisations for compliance. It may be that organisations are unsure of which are really required.

Figures 9,10 & 11: Current alignment to ESG standards across sectors

Source: KPMG LLP, 2023.

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Working on simplification

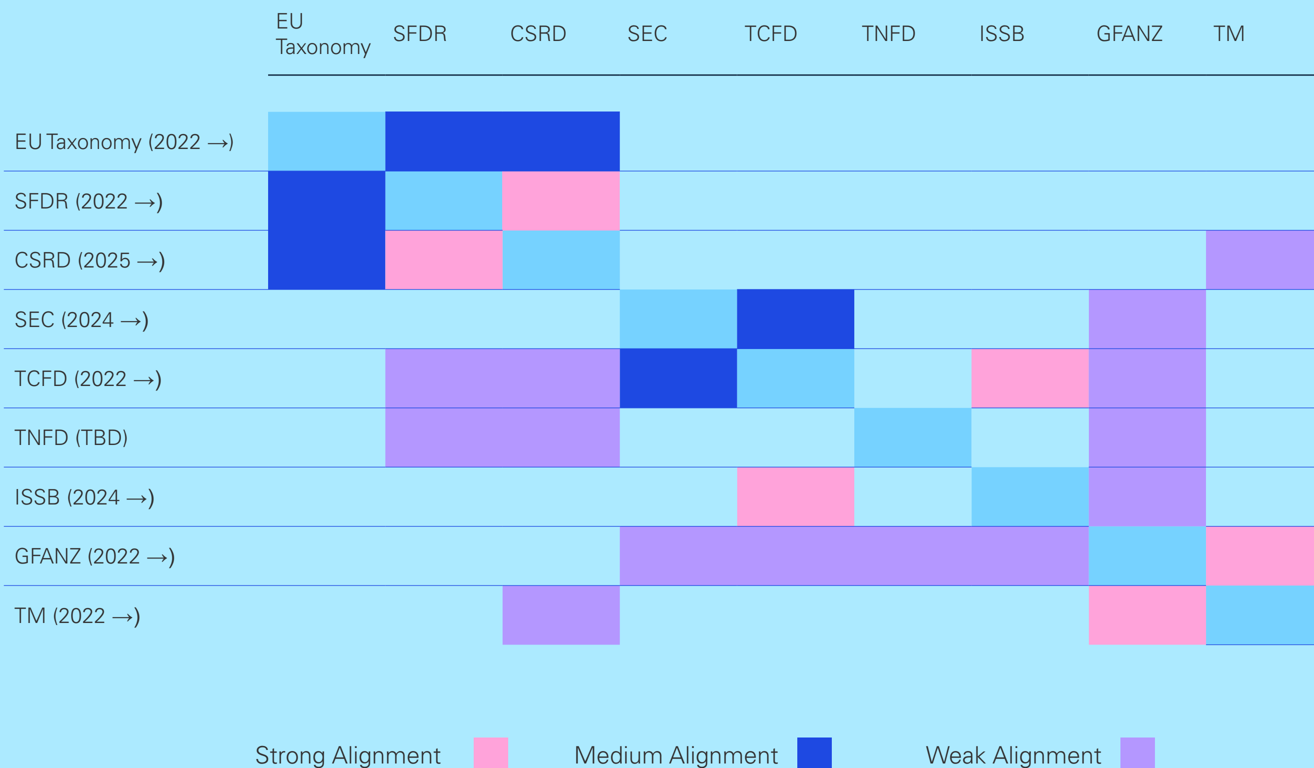
Charlie McLellan
Glasgow Financial Alliance for Net-zero

“ESG regulations and industry standards are emerging across countries and regions at a rapid rate. There are 13+ green taxonomies being developed worldwide, including in the UK, EU, South Africa and Indonesia. Consolidation and standardisation efforts are underway and heading in the right direction.

The TCFD, SASB, Climate Disclosure Standards Board (CDSB) are being consolidated into the International Sustainability Standards Board (ISSB), which is also closely aligned with the CDP. **Regional standard setters need to be mindful to ensure the next wave of standards are globally aligned.** For example, global transition planning industry alliances such as Glasgow Financial Alliance for Net-zero (GFANZ) are working closely with regional developments such as the UK Transition Plan Taskforce (TPT). However, In the current ESG universe, finanacial services firms that operate on a global scale are finding it difficult to navigate the regional and thematic differences and expectations. KPMG are supporting global clients to understand and capitalise on synergies between current and emerging regulations on a thematic and regional basis in order to streamline impactful disclosures.”

Identifying synergies across regulations and industry standards is critical to streamline efforts. TCFD and GFANZ can act as building blocks for regulatory alignment.

Figure 12: Synergies across regulations and industry standards



Source: KPMG LLP, 2023.

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Beyond regulatory compliance, looking to the competitive advantage of ESG integration

Organisations that want to embed ESG priorities in everything they do will not be able to depend on their compliance functions alone to drive this change. In time, effort to look beyond the strictures of regulation will drive broader transformation of the operating model.

Still, it is vital to recognise the rewards for those with the ambition and vision to move forward at pace. There is genuine strategic advantage in responding to regulation with an eye on potential opportunities. In this sense, while the regulatory timeline is challenging, it does at least provide a pathway for organisations to work to – and thus an opportunity to chart a route towards the ESG opportunities many firms recognise.

However, there are more compelling reasons for them to act. Regulators have played an important part in getting the ball rolling and will continue to be an important driver of change. But we also see an acceleration of action, compelled by stakeholder demand, investor return expectations, reputation and risk management. These are now instrumental in driving ESG efforts. We shouldn't be surprised – competitive advantage and protecting the bottom line have always been more compelling than regulatory compliance – but it is important to recognise these drivers as the next wave of change will be both complex and time consuming. Economic benefits – seizing the opportunity and protecting from the risks – will be critical in sustaining ESG momentum.

Six actions financial services firms can do to manage their ESG approach:

1. **Be clear about your sustainability strategy** – and realistic – you may not be able to do everything. What are your firm's core values and how can you put them into action?
2. **Be ambitious** in your efforts to bring about change.
3. **Be prepared to have hard conversations** with your clients and suppliers - think about the businesses you want to be in – and whether they support your sustainability objectives.
4. **Empower your people through education** – from the top to the bottom of the house.
5. Be rigorous in **verifying your data.**
6. Be **transparent with your regulators** – engage with them and be part of the debate – they are learning too.

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Spotlight on America

America appears to be responding to ESG with less vigour than their counterparts in the UK and the EU.

In our Survey of Sustainability Reporting 2022, the clear majority of American respondents say ESG initiatives would take a back seat (slowing down or stopping entirely) in the face of economic difficulty. Less than 20% claim initiatives would progress as planned – by contrast, two thirds of respondents say digital transformation initiatives would progress as planned in the same economic conditions.

Responses to moving forward on ESG are more polarised in America; some appear to be indifferent.

Among American respondents, only about half say they are currently advancing ESG risk and compliance programs. More than half do not accept that climate and sustainability issues create regulatory uncertainty.

However, America's respondents do recognise the economic impact of ESG.

More than half of the respondents agree strong performance against ESG goals drives substantial benefits for banks, including enhanced reputation, increased demand for products and services, greater access to talent, and lower capital costs. Even more than half say they are shifting portfolio strategy away from industries such as oil and gas in favour of clean energy, water, and similarly ESG-focused businesses. Similarly, they expect their non-interest expenses to rise in the year ahead due to ESG compliance readiness initiatives and they plan to purchase assets in carbon markets to meet ESG goals.

Spotlight on China

The maturity of China's approach to ESG may surprise some in the West, particularly in the environmental sphere, where it has made significant progress on renewable energy and decarbonisation. Solar is an increasingly important part of the energy mix, for example, and Chinese adoption of electric vehicles is well ahead of the rest of Asia.

Indeed, China's targets on decarbonisation are ambitious. The country is committed to carbon emissions peaking in 2030, before declining steadily over the following decades; its target is for carbon neutrality by 2060. The new leadership of the country has put sustainable development at the heart of its policy agenda.

Hong Kong, SAR meanwhile, has sought to keep pace with international ESG developments, embracing similar timelines for implementation of initiatives such as TCFD and ISSB as other key financial centres. China's financial sector is regarded as a key engine for enabling decarbonisation of the real economy.

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Closing the data gap

Figure 13: Popular sources of ESG Data

Figure 14: Purposes of ESG tools and models to assess risk and opportunities

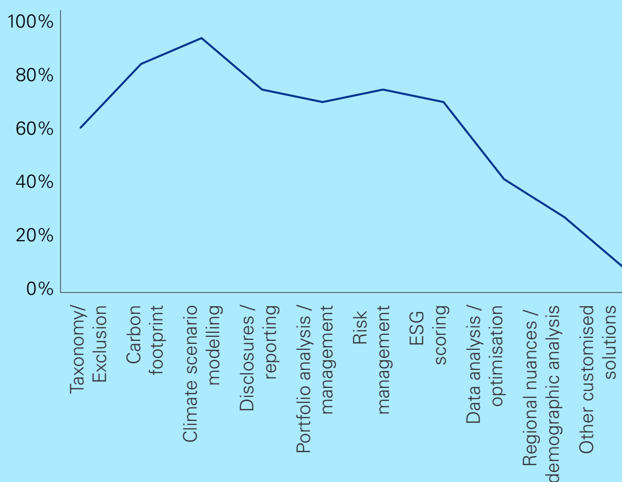
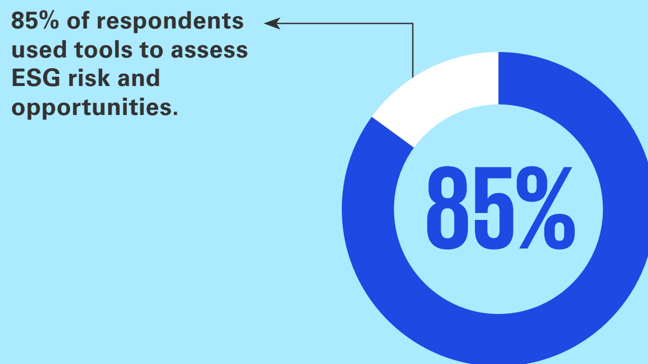


Figure 15: Top three issues with ESG data

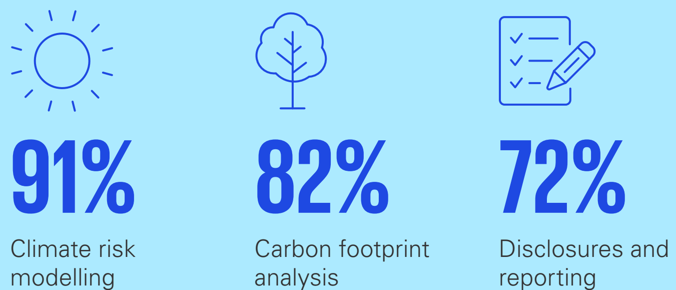
Figure 16: Use of ESG tools

85% of respondents used tools to assess ESG risk and opportunities.



Source: KPMG LLP, 2023.

Figure 17: Popular purposes for ESG tools



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Data is still a stand out issue

Data stands out as a real and ongoing problem for many financial services organisations. They complain that that they cannot get hold of the data they want, and that they do not understand how to use it. They worry about their ability to make informed decisions on key issues from an ESG viewpoint.

It's not as if there is a shortage of potential sources of ESG data. Organisations are already sourcing data from a wide range of providers. Rather, the problem is the nature of what is available, and how to use it against the commitments they have made.

Financial businesses share concerns that:

- Data collectors and providers' outputs are unverified and inconsistent. Aggregators of ESG data are often unable to independently verify data; their outputs may be at odds with each other.
- ESG data is patchy. The quality and quantity of ESG reporting varies by jurisdiction, by asset class, and by size of corporate. In many markets, there is little ESG data for collectors and providers, or financial services firms themselves, to work with.
- ESG data is out of date. Almost all ESG data is backwards looking – often significantly so given the extended timelines of corporate reporting. All assessments of corporates' ESG performance rate the organisation on where it was at a point in time, rather than where it is today.
- There is no single source of the truth. Financial services business cannot find all the ESG data they require from any one provider. They must therefore confront the inconsistencies of ESG data industry and manage the technical difficulties of compiling multiple data sources.

An additional problem is that even when organisations are confident in the ESG data they receive, they lack the skills needed to make good use of it. Almost half the organisations in this research say that data analysis and optimisation has not yet been explored to assess the ESG risks and opportunities that they face. Yet "processes to capture the data and hold across multiple sources" is identified as a key ESG data challenge. Closing the gap needs to come from in-house solutions and firms need to start thinking about how ESG data will weave into their group level data models and architecture.

"Climate disclosure regulation is actually really useful for banks. It will very quickly produce the standardised, reliable data that banks need in order to know where they are in terms of their ESG goals. And also - most importantly - data about the corporates they serve. As we start to see the regulators roll disclosure out to a much wider group of corporates, we can see real solutions to the massive data gaps begin to appear. If banks use that intelligently, they can start to develop products that will then give them a differentiation in the market."

Kay Swinburne
Vice Chair of Financial Services
KPMG in the UK

Organisations need to improve their in-house ESG data operations – to build a data architecture, from group level down, that enables them to capture, aggregate and analyse data, across a variety of sources, and look for ways to automate and streamline. In time, these competencies may enable financial services firms to circumvent many of the problems they encounter with third-party data. However, such change calls for expert data analysis and solutions – and is often constrained by a shortage of talent with the expertise to build such infrastructure. Data management is a clear challenge.

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Solving ESG data challenges

Vinay Singh
Director, ESG Data
KPMG in the UK

"Whether its compiling reporting and disclosure, completing stress tests, preparing for investment or writing and tracking transition plans, our financial services clients are realising that solving ESG data challenges is central to the solution. It's a challenge that is not unique to ESG, which is a good thing, as we can learn from other areas. Data professionals understand the language and processes of data but they often struggle with applying it to ESG.

In order to understand what the solutions look like, we need to start with the common issues. The challenge is to provide a single source of validated non-financial metrics, as the basis for the bulk of non-financial reporting and submissions. Right now, there is a huge amount of manual effort and reliance on complex spreadsheets and other end-user computing.

The adoption of common processes and standards is part of the solution and leads us towards a centralised and unified model which has the capability of shared or federalised use. What we are really looking at in most circumstances is a framework or architecture rather than one tool or a single vendor solution. Of course, something off the shelf is desirable from a cost and ease of use perspective, but more often than not, this doesn't exist or fit particularly well, so development of commercial solutions is required.

Clients' ESG data issues are aligning around a core set of issues, and solutions.

Other key issues – and hence key solutions features – are that the data model needs to be flexible and extendable, so that it can easily adapt to changing scope, regulations and standards. It also needs to integrate with the existing technology stack and be auditable. It needs to be one toolset for environmental, social and governance metrics (both emissions and non-emissions). Automation of data import with a flexible integration layer that supports different file, API and database sources is a further critical feature.

If all this sounds complicated, you are right. The size of the challenge makes it difficult for our clients to commit to an end-to-end solution. The cost of inaction has the potential to be high. Not addressing the data solution means risks of mistakes and inaccurate disclosure is high. Mispricing risk and missing opportunity is also virtually inevitable.

So where do we begin? Our advice is to start small. Building the solution in just one area to minimal viable product (MVP) before delivering a business as usual solution reduces complexity, cost and the risk of mistakes."

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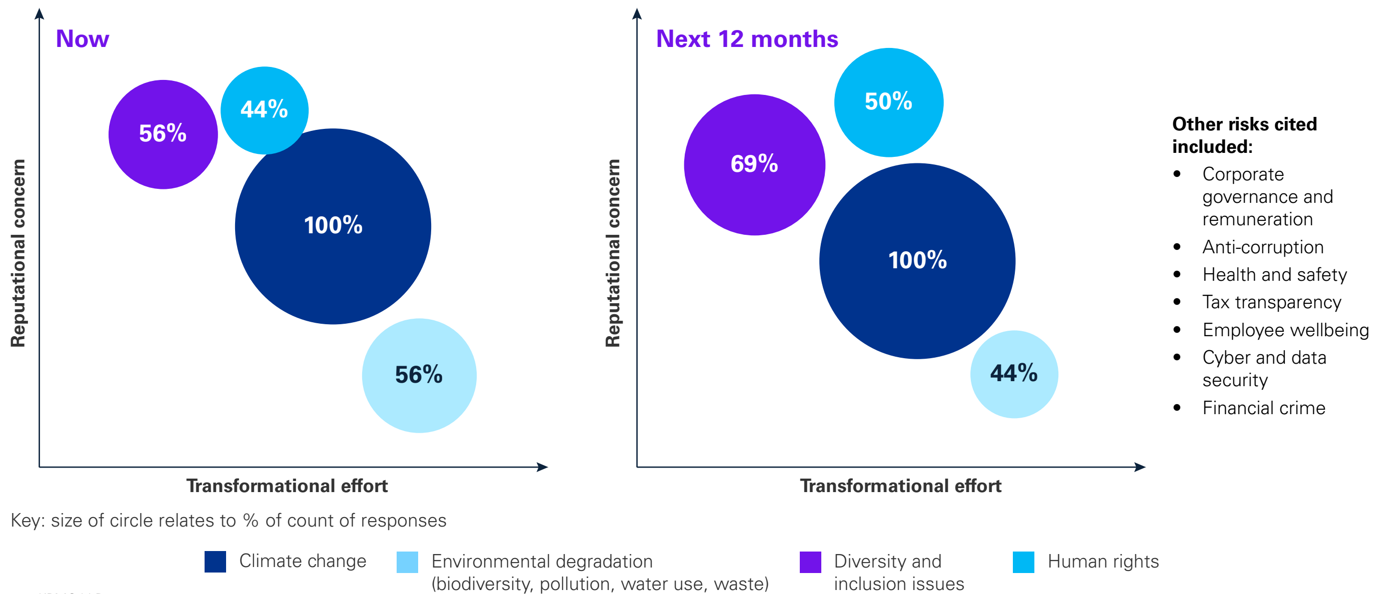
Managing the pace of change

Figure 18: ESG risks deemed significant to organisations now and in the next 12 months

"The environment and climate will require the most transformational effort, but human rights looms as a big reputational risk for financial services"



Other risks cited included:

- Corporate governance and remuneration
- Anti-corruption
- Health and safety
- Tax transparency
- Employee wellbeing
- Cyber and data security
- Financial crime

Source: KPMG LLP, 2023.

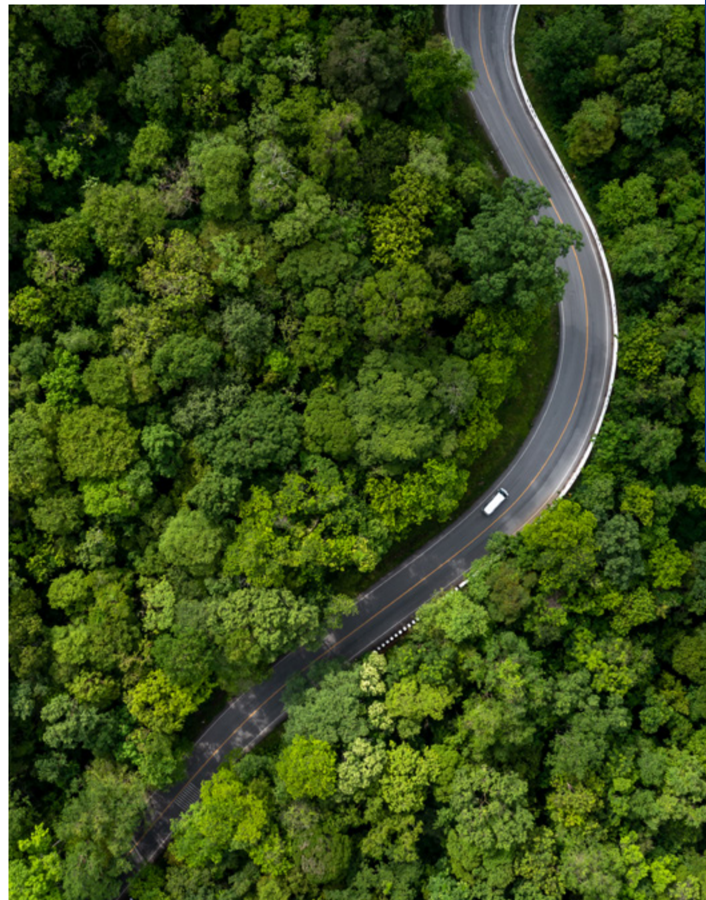
Pressure for change comes from many places and will mean that action is required in a diverse range of areas

Financial services organisations are under pressure to move quickly. The direction of the broader economy is clear and there are both medium- and long-term risks that are increasing the pace.

An ever-growing number of countries are setting net-zero targets, for example, leaving financial services firms with exposure to carbon-intensive businesses increasingly at risk. The rise of social movements – and the ability of campaigners to work collectively and publicly through networks such as social media – gives rise to similar vulnerabilities. 9 in 10 organisations in this research believe that by performing well on ESG criteria, they will drive positive return.

"Whatever the driver, we know from our in-depth engagements that ESG needs to be part of core business strategy, not a tick-box compliance exercise. That said, adherence to regulatory requirements and standards is one of the main ways that firms can demonstrate their ESG credentials and commitments. It is important to recognise there is a genuine strategic advantage in responding to regulation."

Michelle Adcock
Director, Regulatory Insights Services Centre
KPMG in the UK



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Financing the transition emerges as a path to growth

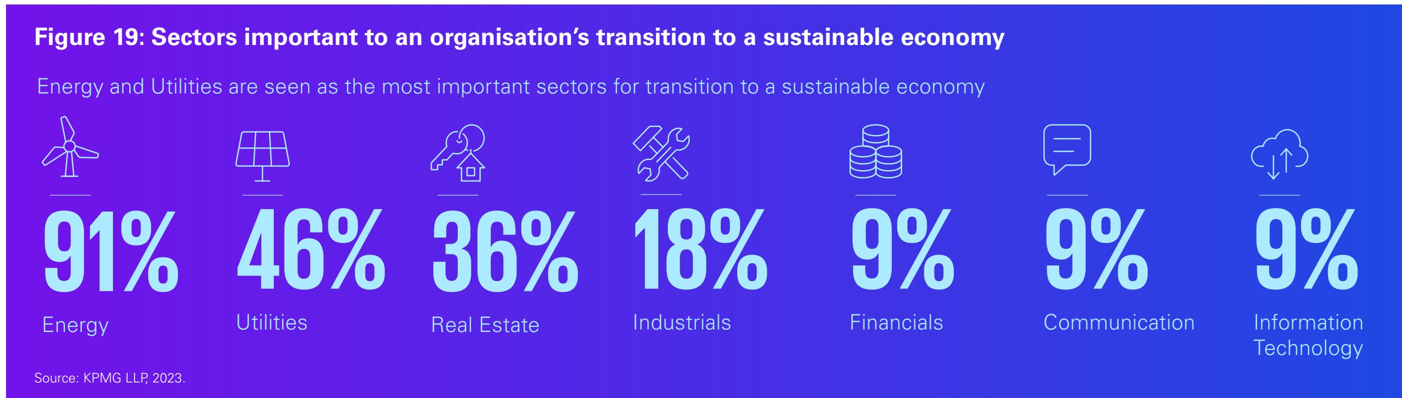
Managing the pace of change is difficult. Regulation can provide a clear pathway, helping firms to understand what is the very minimum they must do and when they must do it by. **But, fundamentally, strategies need to become tangible – something that is reactive and measurable to the real world.**

Financial services businesses will have the greatest impact when they drive positive change at the businesses they lend to, insure and invest in. Currently, however, many firms are considering a strategy of disinvesting (or ceasing to trade with) poor ESG performers, rather than to engage and seek change. This is particularly the case with climate change-related concerns and our research shows that organisations' focus is heavily on divesting from high-emitting sectors.

A related question here is the extent to which ESG investment is genuinely underpinning "new-economy financing". Are financial services organisations financing the transition to a more sustainable world, or simply backing away from businesses with the greatest exposure to the old economy?

The danger is that the latter approach has given a false impression about the returns available from ESG investment. Certainly, an avoidance of old economy exposure has delivered gains in recent times. But what will the returns be from financing a just transition in the years ahead? The opportunity to drive real-economy impact may be being missed and on the goal of ESG, to promote positive change, firms will fall short.

Figure 19: Sectors important to an organisation's transition to a sustainable economy



Source: KPMG LLP, 2023.

Keeping it real – how do we get the public to embrace ESG?

Joe Cassidy
Partner, Financial Services
KPMG in the UK

"The reality of 2023 is one of many challenges. I talk to senior financial services executives every day and they often find it hard to look past the compliance burden of ESG. Too many aspects taking too much time and attention. In the current economic climate, perhaps ESG itself needs a re-boot? Part of the answer lies in reframing, prioritisation and biting off smaller chunks. I see three distinct tactical lenses which would help everyone get to grips with ESG, including, of course, financial services firms, who play such an important role in scaling sustainable change.

Green energy must become the equitable energy solution – that means green energy has to become synonymous with lower prices and easy access. This means affordable heat pump solutions and a huge scale up of electric vehicle charging points, for example. We are at that tipping point now and the dynamic can be changed with the right policies. Once public opinion turns, financial services needs to be ready for this new green demand.

Energy security should be a driver for local renewables investment – the vested interests of the incumbent, carbon intensive businesses are tempting. They say they can provide energy security in the shortest possible timeframe. But this is an illusion – how can continued reliance on imported fossil fuels be a better long-term bet than investing in local solar, wind and hydro, for example? This has to be the better lesson for us to take from the terrible war in Ukraine.

Going green is good for business – every business right now is focused on its 'burn rate'. They are looking at simplification (fewer products, lines of business, reduced complexity), fewer people (because of wage inflation), less Inventory (shifting from "just-in-case" to "just-in-time" – and combined with fewer lines of business) and smaller real estate footprints (less stock / lines, fewer people and work-from-home or hybrid working). The genie is out of the bottle: the green lens is part of how we reduce the burn rate."

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Have we reached the point of too much measurement?

If less is increasingly more for financial services businesses, as KPMG's Joe Cassidy suggests, what does that say about our ever-expanding efforts to monitor and report on ESG activities? Measurement and reporting are an important way for financial services firms to hold themselves to account – but only to a point. Too much information both creates a burdensome environment and, potentially even more importantly, obscures the real picture of firms' performance.

However, there is now a school of thought that less may be more, with a systems-based approach providing an integrated model of risk and opportunity assessment. For those further up the maturity curve, a single report focusing on real-world outcomes may become standard practice.

If financial services firms can deal with the reporting challenge, they can shift resources into the systems and models that integrate ESG decision making into everything they do. This is the key to ensuring real-economy impact. We are not there yet – for example, only a handful of respondents are thinking about fully pricing ESG into their products and services.

Equally, it is important to be realistic. Financial services firms can have impact through their interactions with the businesses to which they lend, where they invest and where they insure. But they will need support from the rest of the world too. ESG action must become everyone's priority.

We are at risk of measuring ourselves into oblivion

Kaisie Rayner

Founder of A Future Worth Living In and consultant to KPMG

KPMG International

"The resources that financial institutions are now required to mobilise to generate 100 page reports barely shift the dial on the reallocation of capital. This reporting burden is set to increase with the need to produce climate transition plans and the TNFD. Fundamentally, the conclusion that many investors may come to is that they cannot move faster than the "real world" decarbonising. So, the most important action is for policymakers to set appropriate policies – rather than for investors to divest or green their portfolios at the expense of greening the world."

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A social strategy for global problems

Elevation of responsibility becomes a necessary precondition

“Where does the buck stop? When I work with organisations that are truly committed to making a difference, I see one common characteristic. It can’t be a coincidence. Regardless of what it is that they are passionate about – call it ‘the mission’ – I see that they have successfully elevated the mission from an operational exercise to a strategic board-level priority. It is not enough for one board member or one department to be responsible. This needs to be the whole board. The mission needs to be elevated such that it is seen as an existential risk to the board and to the company. This is the model.”

Kay Swinburne
Vice Chair Financial Services
KPMG in the UK

Social strategy is moving up the priority stack

Across our financial services client portfolio, we are seeing national and global headlines driving board-level awareness and consequently action. The mission of social responsibility is not only advancing across the organisation (from traditional corporate and social responsibility functions (CSR)), but also being looked for throughout the organisation’s value chain, products, services, and customer selection processes. It is starting to change from an operational exercise to a strategic board priority: identification and management of Inclusion, Diversity and Equality (IDE) strategies, human rights risks, community impact and economic societal contribution is being reviewed more frequently from the top.

Our research confirms what we are seeing on the ground. Longer-standing advocates of social responsibility, such as HR and Inclusion and Diversity functions, continue to play their part: more than 50% of respondents said that HR and Diversity and Inclusion functions hold ESG responsibilities in the organisation and will continue to do so in the future. Information gathering and reporting also appears to be well-established in some organisations, with nearly half of respondents confirming that they currently report social risks externally.

Human rights and modern slavery remain key social risks for organisations. Much of this is driven by reputational risk and regulation. We have seen this in our client engagements with many clients still working through the full implications. In our survey, 62% of our respondents confirmed they will publish specific human rights disclosures in the next few years.

There is a need to go deeper, and it is driven by regulation.

More stringent regulatory obligations are looming in the EU that will affect all aspects of the organisation from a social perspective. The Corporate Sustainability Due Diligence Directive (CSDDD) will introduce mandatory human rights due diligence requirements and a display of preventative action from organisations. The Sustainability Reporting Standards will encourage organisations to dig deeper in their disclosures with S topics expected to include their own workforce, value chain workers, communities, consumers and end users.

Inclusion, Diversity and Equality measures are also pushing firms to go further. In the EU, organisations will soon be required to display more granular evidence of the effectiveness and influence of IDE measures. The European Banking Authority (EBA) recently published their draft guidelines on the benchmarking of diversity practices including diversity policies and the gender pay gap. Banking institutions and investment firms will need to engage a “broad set of qualities and competencies when recruiting members to the management body and promote diversity on the management body”. The EBA is expected to benchmark the effectiveness of this implementation. In-scope firms will need to gather more rigorous data and produce more detailed reporting frameworks to evidence their progress.

This may not be easy. In the UK, the recent Financial Conduct Authority report on D&I strategies published in December 2022 highlighted multiple concerns with strategies to date, including use of diversity data, effectiveness of commitments, strategies and targets, and governance and accountability.

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To meet targets wholeheartedly, organisations need to review their business organically, including their culture, brand, values, communication and marketing. Deeper issues rooted in conscious and unconscious biases must be uncovered or organisations will likely drive disappointing statistics relating to inclusion, diversity, and equality in the workplace.

The demand for a Social agenda is global.

Our results showed that organisations modified their ESG agenda to focus on Social topics as a result of the geopolitical agenda and global impact. COVID-19 was a key catalyst in crystalising a Social strategy over the past couple of years with over half of respondents claiming to have modified their ESG agenda as a result. Another 50% stated that the geopolitical agenda was a key reason to focus on the Social agenda. Furthermore, globalised risk management frameworks are critical for issues like human rights, modern slavery and human trafficking.

Global impacts and diversities are prompting more conscious social action and its reach is the entire value chain – recognition of social risks and impact should include companies' operations, products and portfolios, suppliers, and consumers. The supply chain is another area with huge potential to drive positive social global change, through empowering diverse businesses and mitigating human rights exploitation. Interestingly our results showed that the use of global external data providers, such as MSCI, FTSE Russell, and Bloomberg were used equally for measuring social risk in addition to environmental risk. Companies should leverage similar approaches that have been defined for climate to define and incorporate social.

Joined up thinking is critical in achieving a just transition.

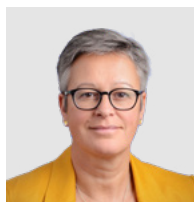
Providing fairer access to finance and considering community impacts across geographies, is one way to advance ESG portfolios and boost sustainable finance strategies. The just transition promotes regional balance and social inclusivity as imperatives when producing green products that are resilient and sustainable. Now, looking to the future, a just transition is becoming a topic of interest which is moving from theoretical to the practical.

It is vital that financial services businesses do not fall into the trap of thinking about individual ESG issues in isolation – they are invariably linked. A just transition to a low-carbon economy will require support for countries and communities currently dependent on fossil fuels and high emitting industries, and recognition across regions that some areas will be ready for greener alternatives much sooner than others. Moreover, many communities and even nations will need financial support just to get close to decarbonising in line with UN targets.

"It is imperative that organisations consider these practical implications when implementing net-zero, climate and environmental targets. Settlement and strategic adjustment in financing is common practice for financial institutions and now ESG calls for just that. Institutions will need to take a strategic approach to transition planning and green finance, one that takes into consideration society and communities as primary stakeholders globally.

This can be considered through multiple lenses. Firstly, responsible divestment and exclusion – organisations will need to anticipate, assess and address adverse social impact across divestment strategies from carbon-intensive sectors. Examples include addressing the reduction or loss of income/jobs through managed phase-outs and considering access to resources for skills development. On the other hand, considering responsible social parameters in sustainable finance strategies is also critical. Green commercial opportunities may come with a price on society and regulators are stressing the importance of identifying minimum social safeguards.

Finally, as we have seen, regional disparities must be considered. Net-zero strategies are being driven by the global West and frequently do not consider differing emissions targets and needs of other countries, including energy security and access to green alternatives. Sustainable finance strategies and transition plans will only withstand the test of time if they consider global dependencies and vulnerabilities and turn these into opportunities. The most mature financial services organisations will recognise these linkages and act accordingly. Some initiatives may be large-scale and holistic in nature, others will be more targeted, but social strategies need to intrinsically consider perspectives worldwide."



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01 State of the Nation
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Methodology

KPMG in the UK researched 27 financial services firms during June and September 2022 to understand challenges around ESG strategy through qualitative and quantitative questions and analysis.

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Document Classificaton: KPMG Public

CREATE | CRT146159A | April 2023