FINANCIAL SERVICES ADVISORY

# Sustainability: The road to regulation

# Sustainability regulation: Why now?

Over the last number of years, the profile of sustainability has grown considerably, but this decade marked a step change. For those on the periphery of the topic, it can at times be overwhelming to keep up with the policy announcements, voluntary initiatives, regulatory implications and stakeholder demands. Here we discuss the background and relationships between some of the key elements and consider what will be coming next.

In the past 50 years the world has experienced unprecedented growth, together with an unprecedented deterioration of natural resources[1]. The world is using resources faster than they can be replenished – activity that is unsustainable. 29 July 2021 marked Earth Overshoot Day[2]; defined as 'the date when humanity's demand for ecological resources and services in a given year exceeds what Earth can regenerate in that year'. The consequences of this behaviour are widespread, long-term and represent a threat to the 'business as usual' model. This require a systems wide change to address the issues, and regulation will be a key driver.

1 Steffen et al (2015). The trajectory of the Anthropocene: The Great Acceleration. The Anthropocene Review, 2(1), 1-18
2 Earth Overshoot Day

# Laying the foundations

### 1980s

The UN sponsored 1987 Brundtland Report[3] (also known as the Report of the World Commission on Environment and Development: Our Common Future) defined sustainable development as "development that meets the needs of the present without compromising the ability of future generations to meet their own needs". While concepts like ethical or responsible practices including investment existed in some form for centuries, this report marked the start of a more formal, integrated approach to the concept. Protection of the environment, and from risks that arise as a result of damage to it were key considerations of the study. A year later, the UN established the Intergovernmental Panel on Climate Change (IPCC) to assess the science-related to climate change, a body that would become seminal in influencing policy discussions.

### 1990

The focus on environmental issues, continued in the early 1990s with the publication of a series of IPCC technical reports outlining the impacts of climate change, together with a range of potential future scenarios. Their reports concluded that emissions from human activities were substantially increasing the atmospheric concentrations of greenhouse gases and modelling predicted that by 2025 global mean temperatures would rise to about 2°C above the pre-industrial baseline[4]. The IPCC also outlined potential implications of this atmospheric change on a range of areas including ecosystems, human habitation, water resources and sea level rise.

The IPCC publications coincided with the United Nations Conference on Environment and Development held in 1992, also known as the Rio Earth Summit. Representatives from 179 countries participated in the event, with the UN Framework Convention on Climate Change (UNFCCC) one of its many achievements[5]. Bodies set up following the conference included the UN Commission on Sustainable Development and UN Environmental Program Financial Initiative (UNEPFI). Both of these bodies have been highly influential in setting the sustainability agenda, with the UNEPFI a sponsor the Principles for Responsible Investing (PRI) - the first of many partnerships with the financial industry aimed at directing capital towards more sustainable activities. The growing interest of investors in responsible investing, as well as burgeoning demand from wider stakeholders for data on the non-financial performance of companies saw the growth of voluntary frameworks like the Global Reporting Initiative (GRI), established in 1997.

### 2000s

In 2000, the UN agreed the Millennium Development Goals (MDGs) - a series of eight goals that together with environmental concerns, also addressed poverty, education, health, and equality with a target date of 2015. At the same time, the UN Global Compact[6] was established - a partnership between business and the UN dubbed 'The world's largest corporate sustainability initiative' to encourage industry to align with, and help deliver, the MDGs. Five years later the Kyoto Protocol, initially adopted in 1997, was formally ratified. A follow up to the UNFCCC, it created binding commitments on developed countries to reduce greenhouse gases, enhancing original voluntary aspirations of the 1992 agreement[7].


3 Report of the World Commission on Environment and Development: Our Common Future
4 IPCC Assessment Report
5 United Nations Conference on Environment and Development, Rio de Janeiro
6 UN Global Impact: 20th Anniversary Campaign
7 United Nations: What is the Kyoto Protocol?

# Defining the direction

**2010s**

**Paris Climate Agreement and EU Sustainable Development Goals**

Perhaps two of the most influential policy decisions were taken in 2015 with the adoption of the Sustainable Development Goals (SDGs) and the Paris Climate Agreement. A follow on from the Millennium Development Goals, the SDGs are a blueprint to achieve a better and more sustainable future for all[8]. They address global challenges, including those related to poverty, inequality, climate change, environmental degradation, peace and justice.

The 17 goals are interconnected and have a target date of 2030. They have been adopted by 193 countries, and the EU links the SDGs to the Union's policy framework ensuring that all Union actions and policy initiatives take the SDGs on board at the outset[9].

In 2016, the 2015 Paris Climate Agreement was ratified[10]. Its primary aims include keeping global temperatures "well below" 2.0°C (3.6°F) above pre-industrial times and "endeavor to limit" them even more, to 1.5°C. Integral to the Paris Agreement is the concept of Nationally Determined Contributions[11] indicating the planned reduction in national emissions through domestic mitigation measures.

These two agreements will inform policy and by implication the economy from this point forward. This milestone marked a recognition of the connected nature of financial, economic, societal and governance factors and the need for an integrated approach to deliver a sustainable future.

Also in 2015, the Taskforce for Climate-Related Financial Disclosures was established. Backed by both the UNEPFI and the IPCC, and created by the Financial Stability Board it published its recommendations in 2017. The report defined physical and transitional climate-related risks, and outlined four areas financial disclosures should focus on; Governance, strategy, risk management, metrics and targets. While the recommendations were initially voluntary, increasingly they have been used as the basis for regulations and between compliance and investor pressure seem set to become the norm rather than the exception.

The UK has already outlined its plans for mandatory TCFD disclosures starting in 2022, and the EU are likely to embed the elements into its recently announced Corporate Sustainability Reporting Directive draft which will impact over 50,000 companies.




8 Sustainable Development Goals
9 EU holistic approach to sustainable development
10 The Paris Agreement
11 The Paris Agreement and NDCs

# Defining the direction

**EU Action Plan**
The recognition that the financial industry will be key to delivering the objectives of both the Paris Climate agreement and the SDGs was integral to the EU Action Plan on Sustainable Finance announced in 2018. It highlighted three key actions:

1. Reorienting capital flows towards a more sustainable economy
2. Mainstreaming sustainability into risk management
3. Fostering transparency and long-termism

A steady stream of interconnected directives and regulation has flowed and continues to flow from this plan, some of which are listed below. The incorporation of these directives has varied, with some national governments strengthening the requirements beyond the original text. Double materiality[12] is a key concept in the EU's approach to disclosures, capturing both the impact sustainability has on the company's performance, as well as the impact the company has environmental and social issues.

The EU Action Plan also mandated the European Banking Authority to consider how sustainability risks and opportunities could be integrated into supervisory expectations. In 2019, the EBA published its Action Plan on Sustainable Finance, outlining a phased approach for a series of reports, guidelines and technical standards that would address these issues. Enhanced disclosures are one of the constant themes of directives, regulations and guidelines, providing stakeholders with information to make informed investment decisions.

**European Green Deal**
The action plan on sustainable finance is a key pillar of the European Green Deal, announced in early 2019. This flagship policy aims to address the climate crisis by transitioning Europe to a low carbon economy while ensuring a sustainable economic growth. As with other policies, the objectives of the SDGs and the Paris Climate Agreement have been integrated.

Under the plan, the EU will:

- Become climate-neutral by 2050
- Protect human life, animals and plants, by cutting pollution
- Help companies become world leaders in clean products and technologies
- Help ensure a just and inclusive transition

**Voluntary initiatives**
The TCFD is just one of a number of initiatives that have strived to link sustainability-related issues with both financial and non-financial performance. These include those developed by:

- CDSB (Climate Disclosure Standards Board)
- SASB (Sustainability Accounting Standards Board)
- IIRC (International Intergrated Reporting Council)
- GRI (Global Reporting Initiative)
- CDP (formerly known as the Carbon Disclosure Project)

Given the crowded reporting landscape, there is a recognised need for consolidation of disclosure types to aid both prepares and users of the data.

The creation of the International Sustainability Standards Board (ISSB) was announced in November 2021[13]. This IFRS body will incorporate The Value Reporting Foundation[14] (a collaboration between SASB and the IIRC) and work to develop IFRS Sustainability Disclosure Standards. In addition, the development of European Sustainability Standards, which are expected to integrate key elements of existing voluntary initiatives like TCFD and GRI standards will help streamline the reporting process further[15].

12 Questions and Answers: Corporate Sustainability Reporting Directive proposal
13 IFRS Foundation creates new sustainability standards board
14 Value Reporting Foundation
15 Proposals for a relevant and dynamic EU sustainability reporting standard-setting

# Paving the way forward

**2020 onwards**
Where previous decades have set the scene for planning, policy and ambition, this decade marks a significant move towards implementation, aided by both regulatory and stakeholder pressures.

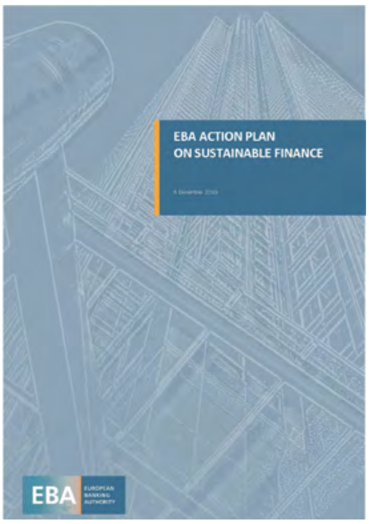
According to the World Economic Forum Global Risks Report 2022[16] "in the 5-10 year horizon, environmental risks such as biodiversity loss, natural resource crises and climate action failure dominate". Two years into the UN designated 'Decade of Change' we have already seen a plethora of policy and regulation relating to sustainability.

The recent COP26 conference coupled with the Biden administration's desire to re-establish a US leadership role in climate change have built on this foundation[17]. This is mirrored by the EU President's flagship policy, the 'European Green Deal', with a climate law, and planned revisions of a range of associated policy instruments and new proposals. Included in these plans are the draft Corporate Sustainability Reporting Directive which, if adopted, will require an additional 40,000 European companies to report audited ESG data.

At a local level, Ireland's first five-year carbon budget has outlined sectoral decarbonisation target ranges and pathways which will influence investment.

Achieving significant reductions of carbon by 2030 is the primary aim of much of this policy, in an effort to avoid average temperatures exceeding 1.5°C above pre-industrial levels. A reduction of 55% by 2030 compared to 1990 levels will be required with implications for all sectors of society; a level of ambition and action on a par with the COVID-19 response. The growing focus on 1.5°C aligned science based targets (akin to nationally determined contributions for business) is shining a light on what individual companies are doing to meet this target, and allowing investors to align portfolios with their climate agendas. Shareholder activism is ensuring this topic is on board's agendas, even going so far as to elect board members on specific climate change platforms.






This decade also marks the start of consideration of sustainability-related risk by financial regulators. Following the 2019 EBA Action Plan on Sustainable Finance, the ECB has issued a series of reports and draft technical standards setting supervisory expectations around sustainability. These include plans to implement climate change stress testing, and requiring consideration of ESG data into credit assessments.

This focus first on climate change, rather than broader sustainability issues (which are not be ignored) reflects the urgent need to rapidly transition to a low carbon economy to mitigate the worst effects of climate change, as well as ensure the financial industry has sufficient capital to protect them from risks associated with this transition.

Disclosure of climate-related financial risks, as well as identification of products that direct capital towards this transition are key to achieving these goals. While Europe is currently one of the world leaders in developing sustainability regulation, particularly in the financial sector, similar moves are taking place globally including the Chinese sustainable finance taxonomy[21] and the SEC considering mandatory climate change disclosure proposals[22].

16 The Global Risks Report 2022
17 President Biden Takes Executive Actions to Tackle the Climate Crisis at Home and Abroad
18 Climate Ambition Summit raises ambition on road to COP26
19 New United Nations Climate Change Report 'Red Alert' for Planet, Secretary-General Says
20 Ireland's ambitious Climate Act signed into law
21 Sustainable finance definitions and taxonomies in China
22 Public Input Welcomed on Climate Change Disclosures

# Where to next?

While concerns around sustainable development and climate change have been raised for many years, what is new is the sense of urgency; the awareness that there is less than ten years to make a difference.

The Sixth Assessment Report (AR6) published by the IPCC makes clear the impact that human activity has had on our climate, and the potential trajectories in the decades to come, dependent on actions that are taken now. The economic cost of not acting, coupled with a socially conscious youth acutely aware that they will bear the brunt of the consequences, and investors who are seeking to build resilient portfolios will result in systematic change across the economy.

Regulation is a key lever in delivering this change and ensuring awareness, compliance and understanding of the wider strategic implications is where Grant Thornton can help you on your journey.

### Immediate focus

- Keeping pace with the sheer volume of discussions papers, supervisory guidance and regulation is the immediate focus of most institutions.
- Beyond traditional finance roles, the integration of climate-related, and wider sustainability risks requires the both significant upskilling, but also further research in a newly developing field.
- In addition, there is data gap where even basic information like physical location of assets, key to understanding physical risks, may not be readily accessible. Granular technical data required to meet standards set out in the EU taxonomy are not routinely collected. New processes will need to be developed to capture this data going forward, but also to consider how to improve the level of data associated with current portfolios.
- While the imminent regulatory burden can dominate the conversation, it's important not to lose sight of the significant investment opportunities. The EU Green Deal in particular envisages €1 trillion of investments over the next 10 years, including an estimated €280 billion of private and public investment[23].

| Year | Key event |
|---|---|
| 1987 | Brundtland Report |
| 1988 | Creation of the Intergovernmental Panel on Climate Change (IPCC) |
| 1992 | Rio Summit |
| | UN Commission on Sustainable Development |
| | UN Environmental Program Financial Initiative |
| 2000 | Millennium Development Goals |
| | UN Global Impact |
| 2005 | Kyoto Protocol Ratified |
| 2012 | UN Conference on Sustainable Development |
| 2015 | Sustainable Development Goals |
| | Paris Climate Agreement |
| | Taskforce for Climate-Related Financial Disclosures |
| 2018 | EU Action Plan on Sustainable Finance |
| 2019 | European Green Deal |
| | EBA Action Plan on Sustainable Finance |
| 2020 | UN Decade of Change |
| | EU Taxonomy |
| | SFDR |
| 2021 | EU Strategy for Financing the Transition to a Sustainable Economy |
| | EU Climate Law |
| | EU CSRD Proposal |
| | EU Fit for 55 |
| | IPCC AR6 - Physical evidence |
| | COP 26 |
| | **What's next** |
| 2022 | EU Social Taxonomy Review |
| | ECB Climate Stress Testing |
| | IPCC Assessment Reports |
| | EU Sustainable Corporate Governance Initiative |
| | EU Review of Biodiversity-related Financial Risks |
| | European Sustainability Standards |
| | EU Taxonomy Disclosures |
| 2024 | EU CSRD Aligned Disclosures |

23 Investing in a climate-neutral and circular economy

# ESG regulation

| | Non-Financial Reporting Directive (NFRD) | Sustainable Finance Disclosure Regulation (SFDR) | Taxonomy regulation |
|---|---|---|---|
| **What?** | Guidelines on reporting of non-financial information relating to environmental, social and governance matters.<br><br>Designed to improve transparency, comparability and encourage a more responsible approach to business. | Regulation which requires financial market participants to disclose how sustainability risks are integrated into the investment process, and additional information for products marketed as pursuing an sustainable investment objective. | An EU-wide classification system to provide businesses and investors with a common language to define and identify environmentally sustainable activities and financial instruments. |
| **Impact?** | The NFRD guidelines were first published in 2014 and apply to large public interest companies including, large financial institutions, with over 500 employees. Updated guidelines were published in 2017 and 2019.<br><br>In 2021 an additional regulation was published requiring in scope companies to publish the alignment of their activities with the EU taxonomy. | Prospectuses and other pre-contractual documents will need to be amended.<br><br>In scope financial market participants should have already started their implementation plans for SFDR Level 1 requirements whilst noting that Level 2 requirements are currently under review by the ESAs which may result in additional change or clarification. | Under Article 8 there is an obligation for in scope NFRD companies and institutions to disclose information on the level of alignment of their economic activities with Taxonomy.<br><br>Disclosures reference opex and capex KPIs which will require significant data collation, especially in the case financial institutions. |
| **Key dates** | Currently live.<br><br>In April 2021, the Commission adopted a proposal for a Corporate Sustainability Reporting Directive (CSRD) which will amend the existing requirements of NFRD. | Level 1 requirements applicable from 10 March 2021 with first publication due on 1 January 2022.<br><br>Application of Level 2 requirements expected in 2023. | Phased implementation from 1 January 2022 with a focus on climate change mitigation and adaptation objectives. |

**NFRD live**
Due to be replaced
by CSRD

**SFDR live**
As at
10 March 2021

**Taxonomy**
1 January 2022

# ESG regulation

| | EBA prudential disclosures | Corporate Sustainability Reporting Directive (CSRD) |
|---|---|---|
| **What?** | New policy strategy on prudential disclosures designed to promote transparency on ESG risks, encouraging financial institutions to strengthen their management of these risks. | Proposal to amend the non-financial reporting directive.<br><br>Requires enhanced sustainability reporting, referencing new reporting standards to be developed by EFRAG, mindful of existing frameworks such as SFDR and EU Taxonomy. |
| **Impact?** | The EBA have provided a number of draft templates and instructions in their consultation paper published March 2021.<br><br>Significant data collation will be required from banks systems and borrowers to provide relevant disclosure info.<br><br>Taxonomy requirements will provide synergies and phased implementation will assist. | Expanded scope to include all listed undertakings in the EU and large private undertakings. Introduces more detailed reporting requirements, requires companies to digitally "tag" reported information.<br><br>Significant data collation will be required together with consideration of how sustainability issues are integrated with strategy. It is important to note that disclosures will be audited. |
| **Key dates** | Following a consultation period in 2021 the EBA published its final draft implementing technical standards (ITS) on 24 January 2022.<br><br>Phased implementation of CRR requirements from 28 June 2022 with full implementation by June 2024. | EFRAG standards are due to be finalised in October 2022, with first disclosures 1 January 2024. Phased implementation for SMEs, with three years delay. |

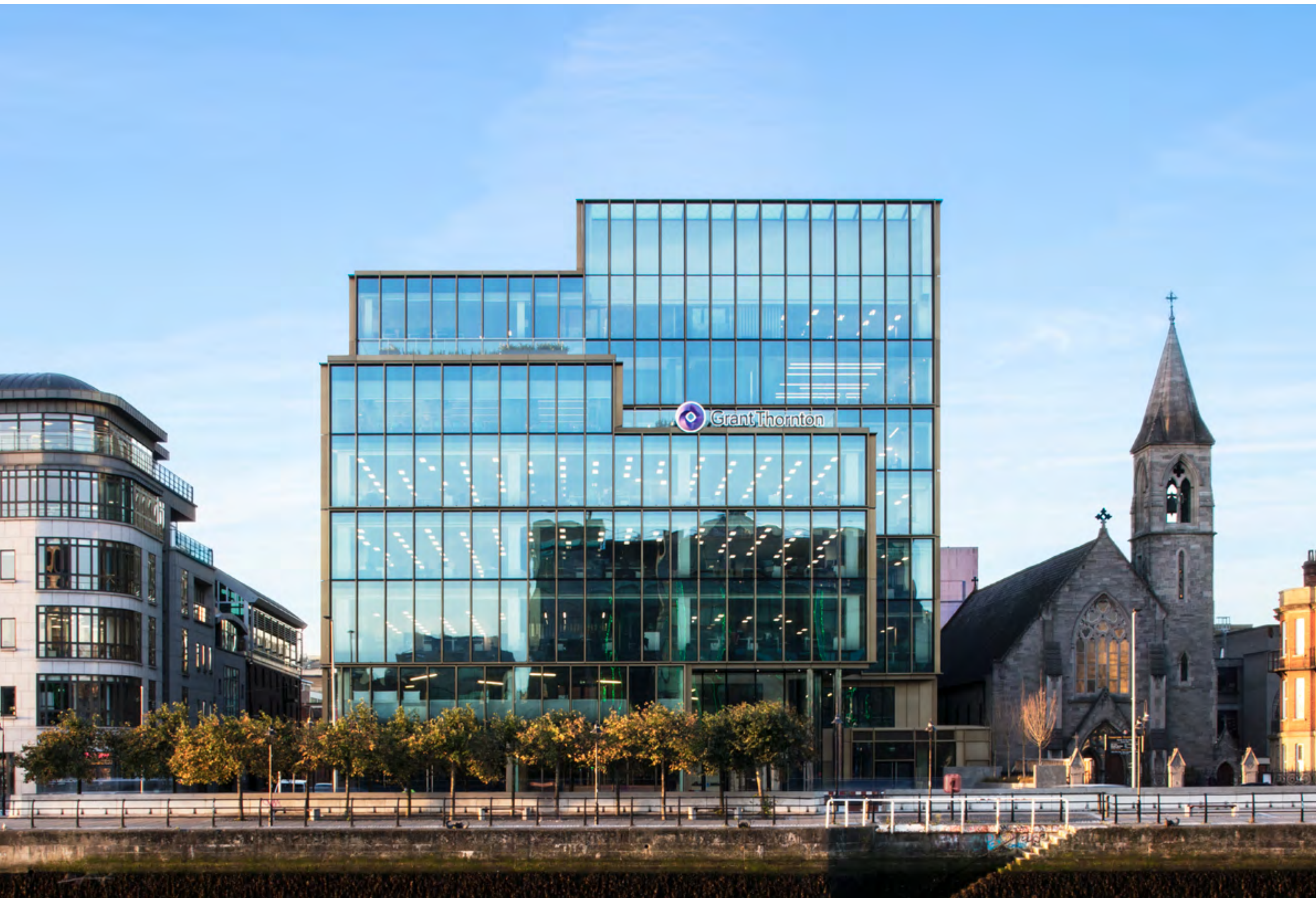
**Prudential disclosures**
28 June 2022

**Sustainability reports aligned to CSRD**
1 January 2024

# Glossary

| Acronym | Description |
|---|---|
| **CDP** | Carbon Disclosure Project |
| **CDSB** | Climate Disclosures Standards Board |
| **COP** | Conference of the Parties |
| **CSRD** | Corporate Sustainability Reporting Directive |
| **EBA** | European Banking Authority |
| **ESG** | Environmental, Social and Governance |
| **EU** | European Union |
| **GRI** | Global Reporting Initiative |
| **IFRS** | International Financial Reporting Standards |
| **IIRC** | International Integrated Reporting Council |
| **IPCC** | Intergovernmental Panel on Climate Change |
| **ISSB** | International Sustainability Standards Board |
| **MDGs** | Millennium Development Goals |
| **PRI** | Principles of Responsible Investing |
| **SASB** | Sustainability Accounting Standards Board |
| **SDGs** | Sustainable Development Goals |
| **SEC** | Securities and Exchange Commission |
| **TCFD** | Task Force on Climate-Related Financial Disclosures |
| **UN** | United Nations |
| **UNEP FI** | United Nations Environmental Program Financial Initiative |
| **UNFCCC** | United Nations Framework Convention on Climate Change |
| **UNGC** | United Nations Global Compact |
| **VRF** | Value Reporting Foundation |

# Contact us




Our dedicated ESG team can provide pragmatic advice on any or all of these considerations as you seek to plan your roadmap to meet the upcoming sustainability reporting requirements.


**Amanda Ward**
Partner,
Financial Services Advisory
T +353 (0)1 433 2440
E amanda.ward@ie.gt.com

**Catherine Duggan**
Director,
Head of Sustainability
T +353 (0)1 433 2535
E catherine.duggan@ie.gt.com


Offices in Dublin, Belfast, Cork, Galway, Kildare, Limerick and Longford.

grantthornton.ie

Grant Thornton Ireland

@GrantThorntonIE

Grant Thornton

**granthornton.ie**