Regulatory Alert

Regulatory Insights

January 2020

Focus on ESG

ESG-related risks (environmental, social, and governance) are evolving from "emerging" risks to foundational factors that must be considered by all companies in all industries across their core risk areas (e.g., scenario model analyses, credit risk, operational risk, reputation, and compliance risks). The attention focused on ESG concerns at the World Economic Forum has prompted heightened attention and action from corporations, public policy makers, and regulators alike.

Key points

- Increasing pressure from investors, employees, customers, and the general public drives companies to commit to and act upon an ESG strategy, even in the absence of specific regulatory requirements.
- Investment funds designed to address investor preferences/concerns for ESG factors have grown exponentially, prompting U.S. regulators to focus on whether the fund investments match their stated strategy.
- ESG-related disclosures are guided by a variety of voluntary frameworks and ratings systems; multiple interpretations exist regarding what "ESG" means as well as what comprises each of the individual components leaving broad discretion to companies and investment advisers.
- The focus on sustainability and climate-related risks at the 2020 World Economic Forum has spotlighted these issues.

The following items highlight the primary focus currently being trained on environmental, social, and governance (ESG) concerns.

- "Stakeholders for a Cohesive and Sustainable World" is the theme of the 2020 World Economic Forum (WEF) convened in Davos, Switzerland the week of January 20, 2020; environmental challenges, and in particular climate-related challenges, were identified as top concerns. A key development included the introduction of a whitepaper by the WEF's International Business Council (IBC), which outlined recommendations for a core set of metrics and disclosures related to companies' ESG performance and contributions to the United Nations sustainable development goals (SDG).

The WEF IBC Initiative is supported by KPMG, as one of the Big Four Professional Services firms, and aims to develop a set of base level, industry agnostic requirements incorporating both financial and non-financial criteria that are primarily relevant for investors. The WEF ESG Reporting Scorecard is clustered around four pillars: prosperity, people, planet, and principles of governance. It is designed to help companies measure and disclose their progress to investors and other stakeholders in a consistent and comparable way.

- Multiple individual companies have publicly announced commitments to ESG strategies that range from how they will interact with their customers to how they will operate their businesses. Examples include:
  - Pledging to reduce reliance on fossil fuels and related products
  - Pledging to reduce carbon emissions
  - Expanding product offerings that meet ESG expectations/standards
  - Promoting ESG disclosures aligned with the Sustainability Accounting Standards Board (SASB) and the Task Force on Climate-related Disclosures (TCFD)
    - SASB is an independent, non-profit organization that sets voluntary reporting standards for companies to convey financially material information on ESG topics to their investors. The standards are industry-specific and were first released in November 2018.
    - TCFD operates under the auspices of the Financial Stability Board (since 2015) and has set a voluntary framework of climate-related financial disclosures.
  - Forming industry coalitions to work on ESG issues.

- The SEC's 2020 Examination Priorities states that the Office of Compliance Inspection and Examination (OCIE) has a particular interest in the accuracy and adequacy of disclosure provided by Registered Investment Advisers (RIA) offering clients new types or emerging investment strategies, such as strategies focused on sustainable and responsible investing, which incorporates ESG criteria. In addition:
  - The SEC is questioning certain advisers' criteria for determining an investment to be environmentally or socially responsible, whether they follow well-known policies such as the United Nations' Principles for Responsible Investment, and how they voted as proxy on ESG issues. The agency is also looking to ensure that funds are investing in a manner that is consistent with the principles they represent to investors (e.g., an "ESG mandate").

- The CFTC established a Climate-Related Market Risk Subcommittee to identify and examine climate change-related financial and market risks. The subcommittee will consider a variety of topics and issues including: integrating climate-related scenario analysis, stress testing, governance, and disclosures into risk assessments and reporting; policy initiatives and best practices for risk management and disclosure in support of financial stability; and the use of data and analytics to assess potential impacts on financial stability indicators such as agricultural production, energy, food, insurance, and real estate. The 35 members of the subcommittee were named in November 2019.

- The Federal Reserve Bank of San Francisco sponsored a research conference to facilitate discussions on quantifying the climate risk faced by households, firms, and the financial system; measuring the economic costs and consequences of climate change; accounting for the effects of climate change on financial asset prices; and understanding the potential implications of climate change for monetary, supervisory, and trade policy.

- The Bank for International Settlements (BIS) published a paper outlining ways in which central banks can address climate-related risks through their financial stability mandate, including developing forward-looking scenario-based analysis and coordinating policy actions among "governments, the private sector, civil society, and the international community" in areas such as carbon pricing, integrating sustainability into financial practices and accounting frameworks, and developing new financial mechanisms at the international level.

Though not specifically intended to meet ESG concerns, actions by the Treasury and federal banking regulators would serve to promote ESG considerations.

- The Treasury Department and the Internal Revenue Service jointly published final regulations implementing the Opportunity Zone tax incentive, which was created by the Tax Cuts and Jobs Act and offers capital gains tax relief for investments in economically distressed areas. Qualified investments in Opportunity Zones may also serve as ESG investments through their social impact, such as real estate re-development and start-up businesses.
  - The OCC and FDIC suggest their recently proposed revisions to the Community Reinvestment Act (CRA) would encourage banks to conduct more CRA activities and to serve more of their communities, including those areas with the greatest need for economic development, investment, and financing, "such

as urban and rural areas and opportunity zones." Under the proposal, the agencies would:

- Recognize community development activities providing financing for or supporting qualified opportunity funds that benefit low- and moderate-income opportunity zones.
- Clarify the criteria to incentivize banks to meet the affordable housing needs of their communities through activities including workforce housing (a qualified Opportunity Zone investment) that would allow public employees, such as teachers, police officers, and firefighters, to live close to the communities they serve.

For additional information please contact Amy Matsuo or one of KPMG's ESG Network of professionals: Ruth Tang (Audit), Joanne Beatty (Advisory), or Orla O'Connor (Tax).

Amy Matsuo
Principal and National Lead
Regulatory Insights
T: 919-664-7302
E: amatsuo@kpmg.com

Contributing authors:

Amy Matsuo, Principal and National Lead, Regulatory Insights

Karen Staines, Director, Regulatory Insights

kpmg.com/socialmedia