ESG integration at the Time of COVID-19

Executive Summary

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Introduction

Climate change and the necessary energy transition, as described in the *European Green Deal*[1] of the European Union (EU), are clear and well-known issues and can no longer be considered a secondary problem even in the situation of the health and economic crisis of Covid-19. The economic recovery must start from the real economy and from those sectors that present more just and inclusive activities with low environmental impact, resilient to

[1] This growth strategy aims to transform the EU into a just and prosperous society, with a modern and efficient economy, which in 2050 no longer generates net greenhouse gas emissions and with economic growth decoupled from resource use. It aims to protect, conserve and improve the EU's natural capital and to protect citizens' health and well-being from environmental risks. The Green Deal is an integral part of the Commission's strategy to implement the 2030 Agenda and for this reason it foresees that at the same time, this transition must be fair and inclusive. Ref. https://ec.europa.eu/info/publications/communication-european-green-deal

climate change.
Among the many studies aimed at highlighting the link between climate and health, there is the 2019 Lancet Countdown Report[2] which associates climate change with an increased spread of infectious diseases, some of which are already known as dengue and malaria. Health is aggravated by impacts of poor food safety, extreme weather events and air pollution. The Intergovernmental Group of Experts on Climate Change (IPCC)[3] in the various special reports of 2019 reiterated once again, how the anthropogenic activities that cause emissions can themselves cause direct damage to our health.
The World Economic Forum (WEF) in the recent Global Risks Report 2020[4] also highlights that climate change is the greatest threat to global health in the 21st century and exacerbates the incidence of infectious diseases. Health systems around the world are poorly prepared for significant outbreaks of other emerging infectious diseases, such as SARS, Zika and MERS whose rapid and massive spread aggravated by resistance to antibiotics, antivirals and other treatments leads to widespread fatalities and economic disruption.
The current crisis calls for a systemic approach that pays attention to the different dimensions of sustainable development in the medium-long term. In Europe, environmental action has been defined as primary and urgent and the activities connected to this action have not stopped, even in the peak of the pandemic. In fact, in the first quarter of the year 2020 the milestones of the European Green Deal were presented, including: the proposed *European Climate Law*[5], the regulation on the *EU Taxonomy for Sustainable Activities*[6] and the *New Circular Economy Action Plan*[7].
EU policy-making will not be enough to ensure the achieving of the objectives of the Green Deal. A positive outcome will be related to an efficient exchange of environmental, social and corporate governance or ESG data and information between companies, financial analysts and investors. However, current metrics often seem insufficient and companies face many difficulties while disclosing non-financial information. With the outbreak of the COVID-19 crisis, among the current ESG metrics, the social ones are proving to be less representative of the reality that many companies are facing. That is why it is crucial to test these metrics and keep the dialogue between companies, financial analysts and investors open with the purpose to ensure that companies are using them dynamically and strategically. Companies, investors, analysts and other market players should consider the current crisis like an opportunity to change mindset and to broaden the use ESG metrics and materiality rationale as an activity to inform corporate strategy, not just to report and to use ESG disclosure for orientating capital flows towards impact investment to finance the economic recovery.
This paper hopes to give a general state of play on ESG integration and supported by company case study/studies will assess if current metrics methodology is valid and will survive the COVID-19 crisis.

1. *Climate and European ambitions*

The EU is committed to reaching ambitious climate and energy targets by 2030, in line with the 2030 Agenda and the United Nations Sustainable Development Goals (UN SDGs) [8] and the 2015 Paris Agreement (COP21)[9]. In October 2018, with the communication about long-term strategy "*A Clean Planet for all*", the EU revealed its desire to become climate neutral by 2050.
Supporting this ample and complex project is the *European Action Plan on Financing Sustainable Growth*[10] (Action Plan) presented by the European Commission in March 2018. The Action Plan aims to *i*) redirect capital flows towards sustainable investments, *ii*) integrate sustainability into risk management and *iii*) promote long-term transparency in financial decisions. The recent regulations and the elaborate legislative proposals of the

[2] The Lancet, (11/2019), The 2019 report of The Lancet Countdown on health and climate change: ensuring that the health of a child born today is not defined by a changing climate, Vol 394, www.thelancet.com Accessed June 30, 2020
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[10] https://ec.europa.eu/info/publications/180308-action-plan-sustainable-growth

Technical Experts Group in the field of sustainable finance (TEG) are the result of the tight work schedule that the European Commission has carried out through the establishment, in October 2016, of the High-Level Expert Group on Sustainable Finance (HLEG). In this context, the role of financial analysts in integrating environmental, social and corporate governance (ESG) issues in financial analysis and the ability of companies to provide smart information[11] is essential.

2. *Extra-financial and TCFD*

The European Commission states that *companies do not report all the non-financial information that users deem necessary and many companies report information that users do not consider relevant*. Ultimately, the main difficulties concern the following negative aspects *i*) extra-financial information that is not sufficiently comparable or reliable *ii*) extra-financial information that does not suit users' needs *iii*) unnecessary and avoidable costs incurred to communicate extra-financial information and *iv*) uncertainty and complexity in deciding which, how and where to report extra-financial information.
Certainly, one of the most relevant international developments, related to the Union's initiatives and which the European Commission takes into account, is the activity of the Task Force on Financial Information on Climate (TCFD) [12] to develop recommendations for voluntary communications of financial risks related to Climate.
The final recommendations of the TCFD[13], published in June 2017, focus their attention on the exposure to these risks by companies, which are invited to actively use the "scenario analysis" in order to evaluate effective corporate resilience policies that allow facing different climate change trends. The recommendations focus on helping companies identify and communicate the potential financial impacts of climate-related risks and opportunities on their businesses and are divided into four thematic areas:

- *Governance*: company's management policies regarding climate-related risks and opportunities;
- *Strategy*: the current and potential impacts of climate risks and opportunities on company activities, strategy and financial planning where such information is relevant;
- *Risk management*: the identification, assessment and management of climate-related risks by the company;
- *Metrics and objectives*: the elaboration and monitoring of objectives and the management of metrics used to evaluate and manage risks and opportunities related to climate.

In June 2019, the European Commission published further guidelines on the communication of non-financial information, related to the climate[14]. These guidelines supplement the recommendations of the TCFD in order to be consistent and in line with the non-financial reporting directive (NFRD). Achieving climate neutrality has a certain priority for the EU, therefore there is a need for companies to understand, communicate and better face the risks of a negative impact of their activity on the climate and, conversely, the risks that climate change represents for their business.

3. EU Taxonomy for Sustainable Activities

In line with the principle of double materiality, previously indicated, it is good to clarify that climate information must include both the main risks for the company deriving from climate change, and the main risks of negative repercussion on the climate deriving from the activity itself . The entrepreneurial ability to consider and manage climate risks can lead to new opportunities for the company or products and / or services capable of contributing to climate mitigation and adaptation[15].
Climate disclosures must follow a structure that covers five areas: the business model, policies and due diligence, the result of the policies, the main risks and their management and finally the impact of the business on the climate. These topics serve to direct the company in communicating the information necessary to allow understanding of the progress, results and impact of the activity.

[11] Specific, measurable, achievable, relevant and time-bound. Rif. UNGC e GRI. Business Reporting on the SDGs: An Analysis of the Goals and Targets
[12] Created in December 2015 by the Financial Stability Board (FSB) upon the request of G20 finance ministers and central bank governors. set up a task force
[13] https://www.fsb-tcfd.org/publications/final-recommendations-report/
[14] https://ec.europa.eu/finance/docs/policy/190618-climate-related-information-reporting-guidelines_en.pdf
[15] By adaptation to climate change we mean the process of anticipating the negative effects of climate change and adopting appropriate measures to prevent or minimize the damage that may result (new technologies for a more efficient use of limited water resources or construction of new flood defenses). Climate change mitigation refers to the effort to reduce or prevent greenhouse gas emissions (development of renewable energies and development of more efficient buildings and transport systems).

The taxonomy of sustainable economic activities proposed by the European Commission aims to identify and classify climate-related opportunities. It will then expand to other environmental objectives and eventually to social ones. The final report on the EU Taxonomy[16] published in March 2020 by the TEG encloses indications for businesses on how to implement, use and communicate the taxonomy.
The classification of eco-sustainable activities is the basis of the legal requirements to determine the degree of environmental sustainability of the investments and is the reference of the Action Plan regulatory initiatives already adopted or in progress. This substantial definition work will therefore be the reference for all future EU laws which aim to facilitate the shift of investments towards eco-sustainable economic activities.

4. ESG data and extra-financial corporate reports

In absence of a shared standardization of technical standards, their widespread and official disclosure, it is not easy to read and evaluate the corporate extra-financial data, known by practitioners as ESG data[17]. Disclosure ESG data is now synonymous with a valuable proposition for the company, which can thus demonstrate to convey the company's activity towards the creation of value in the medium-long term, with particular attention to the mitigation of ESG risks[18].
To get competitive advantages that can arise from sustainability, the company will have to develop a certain awareness on the topic and translate it into a corporate vision and strategy that will allow it to evaluate how sustainable issues can impact the business in the short, medium and long term.
There are four business areas that must be analyzed as indicated by the approach of the guidelines on the communication of information related to the climate of the European Commission[19]:

Business areas and ESG Integration

Table 1. Company Areas and ESG Integration

1. Business Model	The corporate vision confirms the importance of sustainable issues and how it can impact the business model and corporate strategy and how vice versa corporate activities can influence these issues in the short, medium and long term.
2. Governance and management control	Company policies and due diligence processes are the key to understand the robustness of the company's sustainable approach. Indicators of corporate awareness are the involvement of the Boards of the Directors and the definition of responsibility on this topic.
3. Corporate outcome	The disclosure of ESG KPIs helps to monitor and control the strategies implemented by the company and the outcome obtained with respect to the defined corporate objectives.
4. Management Risk	The analysis of potential risks, through a clear and transparent methodology and their management is crucial to understand if the company has taken ESG risks into account in the short, medium, long term.

Source: Guidelines on non-financial reporting: Supplement on reporting climate-related information (2019/C 209/01)

Once the awareness of the company's ESG issues and the potential associated risks has been ascertained, the availability of ESG KPIs must be analyzed: significance and comparability of the various KPIs is limited due to the discretion with which they have been defined both on voluntary and regulatory point of view and regional and

[16] https://ec.europa.eu/info/files/200309-sustainable-finance-teg-final-report-taxonomy_en
[17] ESAs Draft on regulatory technical standards with regard to the content, methodologies and presentation of ESG disclosures is currently in consultation (April 2020)
[18] Examples of risks include climatic ones. These can be divided into a) physical risks (chronic or acute), with the ultimate loss of assets and consequences on business continuity, b) technological risks, connected to the transition to a low carbon economy, c) legal risks, which refer to the ability to anticipate possible changes in the regulatory framework, d) reputational risks, which concern pressure on the financial community for a greater commitment to climate containment and adaptation, e) social risks, directly or indirectly connected with rising temperatures and with the increase in extreme weather events.
[19] EUROPEAN COMMISSION, COMMUNICATION FROM THE COMMISSION Guidelines on non-financial reporting: Supplement on reporting climate-related information Brussels, 17.6.2019 C(2019) 4490 final

sectoral specificities, but improvements of the various indicators are expected in the future.
Pending the effective standardization or recognition of best practices in the identification of E, S and G data, it is useful to consider the work done by the initiative of the World Federation of Exchanges (WFE) together with the UN Sustainable Stock Exchanges (UN SSE) in creating the Model Guidance on Reporting ESG information[20].

Table 2. WFE Material ESG Metrics

Environmental Metric	Social Metric	Governance Metric
- Emissions GHG	- CEO Pay Ratio	- Board Diversity
- Emissions Intensity	- Gender Pay Ratio	- Board Independence
- Energy Usage	- Employee Turnover	- Incentivized Pay
- Energy Intensity	- Gender Diversity	- Collective Bargaining
- Energy Mix	- Temporary Worker Ratio	- Supplier Code of Conduct
- Water Usage	- Non-discrimination	- Ethics & Anti–Corruption
- Environmental Operations	- Injury Rate	- Data Privacy
- Environmental Oversight	- Global Health & Safety	- Sustainability Reporting
- Environmental Policy	- Child & Forced Labor	- Disclosure Practices
- Climate Risk Mitigation	- Human Right	- External Assurance

Referring to the methodology used by NASDAQ in the Guide "ESG Reporting Guide 2.0" below we present the analysis of the ESG KPI - Energy mix - a support resource for financial analysts as described in our white paper for all the metrics from World Federation of Exchanges in "ESG Guidance and Metrics – rev June 2018".

5. *Case Study*

As stated in the introduction, sometimes metrics are unable to present a complete picture of the company's practices and performance on ESG. At the same time, many studies[21] demonstrate that company non-financial reporting is very weak, especially in some areas such as risk management and board oversight.
To achieve better outcomes, it is crucial to keep a continuous dialogue between investors, financial mediators, and companies on how to best mirror the company's ESG practices in a defined framework or metrics. Especially, in the current context of the COVID-19 outbreak, a dynamic approach is key to understand which metrics are more relevant in the current situation where companies are operating, and which ones will survive the current crisis.
A good starting point to do so is testing with companies an already existing methodology, to give a picture on what is still suitable today and where there is still work to do in the identification of well-defined metrics to measure and report Environmental, Social and Governance practices.
In our exercise, we considered mostly metrics related to Environmental issues, but, to make our analysis more complete and fit in relation to the current situation, we included as well one metric under Social pillar and one under Governance.
The exercise involved on a voluntary basis companies representing the following sectors: Energy, Cement, Chemical and Oil & Gas and were conducted using a questionnaire created on AIAF's elaboration of the 10 environmental metrics proposed by the WEF and Nasdaq's ESG Reporting Guide.

[20] Rif.: NASDAQ ESG Reporting Guide 2.0, https://www.nasdaq.com/docs/2019/11/26/2019-ESG-Reporting-Guide.pdf
[21] Some of the more relevant studies are:
- EUROPEAN LAB@EFRAG, "*How to improve Climate-related Reporting*", 2020, http://www.efrag.org/Lab1?AspxAutoDetectCookieSupport=1
- Alliance for Corporate Transparency, "*2019 Research Report*", https://www.allianceforcorporatetransparency.org/assets/2019_Research_Report%20_Alliance_for_Corporate_Transparency-7d9802a0c18c9f13017d686481bd2d6c6886fea6d9e9c7a5c3cfafea8a48b1c7.pdf
- Econsense, "*New Momentum for Reporting on Sustainability*", 2018, https://econsense.de/app/uploads/2018/10/econsense_Study-on-Implementation-of-the-German-CSR-Directive-Implementation-Act_2018.pdf
- TCFD Review 2019, "*Task Force Climate-related Financial Disclosure. Status report 2019*", https://www.fsb-tcfd.org/wp-content/uploads/2019/06/2019-TCFD-Status-Report-FINAL-053119.pdf

The six clusters touched were: (1) Emissions, (2) Energy, (3) Water and Environment Management, (4) Board and Climate Management Oversight (5) ESG Reporting, (6) Health and Safety. During the interviews, the companies were also asked to go beyond the questionnaire and indicated their perspectives and comments on the future of ESG metrics and in general sustainability reporting.
Some trends emerged clearly from the exercise, in particular the following examples:

- Increasing attention to sustainability by the board and public opinion
- Arising need to report how companies managed the double crises they are facing: the health and the economic ones, as well as the rebound for recovery. This will leave a lasting impression of what their true sustainability priorities are.
- Renewed attention to quality of life and how companies are contributing to that.
- Growing need for better metrics on many aspects of sustainability: biodiversity, climate, social aspects, including diversity and looking more at the quality of life, resource management. Except for biodiversity and social aspects, it seems like there will be no need at least in the short term for new metrics. Companies will, however, include new content in relation to how they managed the pandemic crisis and the rebound.
- Increasing need to better assess the interconnectivity among the different aspect of sustainability (e.g. what is the impact of biodiversity loss and climate change on social aspects? How well we connect the S aspects to the E?).
- Doubts on the need for companies' metrics related to resilience to pandemic. It would be better to use horizontals indicators – meaning indicators that can be applied to a wider range of circumstances and already existing ones -than specific 'ad hoc' criteria. Some companies questioned the importance of resilience over flexibility to react. While resilience means reacting to something to avoid its negative impacts, flexibility includes managing the crisis actively. Investing on a flexible model before (e.g. digitalization and teleworking policies) can save its stability of the company in times of crisis – reacting to a pandemic is something but being ready to manage the situation is something completely different.
- Growing attention on reporting exercises to deal with a new debate on supply chain management and what is the responsibility of companies also over the current due diligence frameworks.

Conclusion

The management of ESG factors creates financially measurable consequences for the company and impacts the ability to carry out the business strategy and to generate value in the long term. Therefore, it is crucial to encourage companies to consider this extra-financial information as well as to address costs and benefits.
This study focuses on metrics and tests how corporates actions are influenced by sustainability changes, in particular how these changes affect data production, usage and monitoring and on governance attitude. The paper aims to understand from practical examples how ESG integration is being undertaken by companies and how did Covid-19 impacts it.
The current COVID-19 pandemic highlights the need to strengthen the sustainability and resilience of our societies and the ways in which our economies operate. The risks for economy in our system are more likely to arise with the growth of climatic and environmental impacts. Therefore, it is essential, especially in these times, to build more sustainable, equitable and resilient economies by aligning short-term recovery efforts with the medium and long-term objectives of the Paris Agreement and the United Nations Agenda for Sustainable Development. The transition to a low carbon economy implies a boost to economic activity, job creation and overhaul of supply chains.
Surely, the evolution of European and international scenario on ESG disclosure, as well as the growing attention of corporates and investors in the field demonstrate that ESG disclosure is becoming mainstream in the market and Environmental, Social and Governance information will play a leading role for the financial stability of the companies in the future.
The pandemic has highlighted also the relevance of the Social dimension, however the complexity is wide, because all the dimensions of E, S and G are interconnected and COVID-19 has taught us that we must not think in a logic of separate silos and we must not forget that this crisis has its origin in the loss of biodiversity, rapid urbanization, increase in population levels and as humans come into closer contact with animals through deforestation and bush meat markets. This link between climate and health is emphasized, as previously

mentioned, by the Lancet Countdown 2019 report which associates climate change with a greater spread of infectious diseases, aggravated by poor food safety, extreme weather events, air pollution and heat waves.
To conclude, the current crisis requires a systemic resolution approach that looks at the different dimensions of long-term sustainable development. One example of this approach is the use of public finance for sustainable development, like in the case of the vigorous monetary and fiscal policies just implemented in the Eurozone which are in line with the demand to overcome the current crisis. However, this demand must incorporate as well long-term strategic policies for an effective transition to a climate-resilient low-carbon economy. This is the only truly effective vaccine to address not only climate risks, but future social and economic risks as well.

You can download the full study "ESG integration at the time of COVID-19" by AIAF and CSR Europe at the following link:

AIAF: https://www.aiaf.it/aiaf-sostenibilita

CSR: https://www.csreurope.org/library

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was founded in 1971 and counts over 1000 members who work in banks, SIMs, SGRs, investment funds, corporations and independent professional firms. As part of the International ACIIA (Association of Certified International Investment Analysts) and EFFAS (European Federation Association of Financial Analysts Societies) networks operating in 23 European countries with round 16000 members, the Association contributes in its role as Standard Setter towards the development, transparency and the efficiency of financial markets. The latter thanks to its work groups dedicated to numerous topics influential for financial activities, such as fundamental analysis, sustainability, Fintech and, more generally, in all areas in which the ability to perform in-depth and relevant analyzes is now essential. AIAF Financial School directly offers training courses certified through CEFA international diplomas "The Certified European Financial Analyst", CIIA "Certified International Investment Analyst" and CESGA "Certified Environmental Social and Governance Analyst", the latter dedicated to sustainability.

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