Keeping Pace with ESG Disclosure Requirements

An Overview of Recent ESG Developments from Regulatory Institutions

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Introduction

In the past year, the global push for more transparent reporting on environmental, social, and governance impacts (ESG) has accelerated significantly. While European regulators have led the charge, the U.S. is now working aggressively to catch up with its own requirements for businesses and financial institutions. This includes large U.S. banks that control funding and lending worldwide, small banks that provide FDIC insurance to retail clients and SMBs, all publicly listed companies, and all private and public businesses seeking regular insurance policies.

The pressure is coming from all sides, and the actions of regulators in the U.S. and overseas will have a significant impact on businesses across sectors. In fact, over the next few years, companies that fail to reliably report on ESG, including high-quality data on their carbon footprint, could face an existential risk due to reduced appetite from banks, investment funds, and insurance agencies.

In this white paper, we will provide an overview of recent ESG developments from U.S. regulatory institutions, including the SEC, OCC, FDIC, and NAIC. We will also discuss the Corporate Sustainability Reporting Directive (CSRD) adopted by the European Parliament, and its implications for EU and non-EU entities.

Securities and Exchange Commission (SEC)

On March 21, 2022, the SEC proposed rule changes that would require public companies to include various climate-related disclosures in registration statements and periodic reports.

The 490-page report includes requirements for the release of information on certain climate-related risks that could "materially impact" a business's operations and/or financial health, as well as the integration of various climate-related metrics into audited financial statements. The proposal focuses specifically on increasing transparency around GHG emissions of all classifications (Scope 1-3).

The SEC's formal public comment period closed in July 2022, and the institution is expected to approve the proposal in Q1 2023 at the earliest. All businesses required to report under the new rules will have an initial phase-in period for Scope 1 and 2 emissions and a separate phase-in period for Scope 3 emissions. Phase-in periods will also be provided for assurance, and all compliance deadlines will depend on the registrant's filer status, as shown in the table below.

SEC Filer Status Definitions - Center for Audit Quality (thecaq.org)

Public Float[1]	Annual Revenues	Status	Required to Obtain Auditor Attestation over ICFR?	Filing Deadline for Periodic Reports	
				Annual	Quarterly
$700 million and greater	No requirement	Large accelerated filer	Yes	60 days	40 days
$75 million to less than $700 million	$100 million or more	Accelerated filer	Yes	75 days	40 days
$75 million to less than $700 million	Less than $100 million	Non-accelerated filer	No	90 days	45 days
Less than $75 million	No requirement		No		

1) As of the last business day of the issuer's most recently completed fiscal quarter.

The proposal also includes a safe harbor for liability for Scope 3 emissions disclosures, an exemption from the Scope 3 disclosure requirement for smaller reporting companies, and forward-looking statement harbors under the Private Securities Litigation Reform Act "to the extent that proposed disclosures would include forward-looking statements."

Office of the Comptroller of the Currency (OCC)

In late December of 2021, the OCC announced draft principles to "support the identification and management of climate-related financial risks." The new guidelines, which include the requirement to disclose and address both "physical and transition" risks related to climate change, will be applicable to large banks managing more than $100 billion in total consolidated assets and are expected to be approved in the first quarter of 2023.

While the rules will officially apply only to large banks, they will also have significant implications for all banking operations that deal in commercial and retail financing, wealth management, and private and retail banking (including retail mortgages). Because the OCC's ultimate goal is to increase the active awareness of banks regarding the emissions their operations finance with entrusted capital, companies with no known emission disclosures (particularly for Scope 1 and 2) may run the risk of reduced interest by banks to provide financing. Moreover, under the emergent OCC guidelines, it will be critical that entities source climate-related risk management and emissions data from counterparts, and have all information validated by third-party assurance companies and/or internal banking teams.

Separately, in direct relation to the OCC's mission to improve the financial sector's overall posture regarding climate-related financial risks, the Federal Reserve Board (FRB) recently announced that six major U.S. banks will be participating in a "Climate Scenario Analysis Pilot." Expected to begin in the first quarter of 2023 and continue through the calendar year, the objective of the exercise will be to improve the ability of large banks to identify and mitigate climate risks, as well as to establish near and long-term guidance and expectations around climate-related risk management and reporting in cooperation with the OCC and Federal Deposit Insurance Corporation (FDIC).

Federal Deposit Insurance Corporation (FDIC)

In October 2022, the acting chairman of the FDIC gave a speech outlining the agency's efforts to address climate-related financial risk through a cross-disciplinary, interagency approach. The speech covered the FDIC's recently approved Statement of Principles for Climate-Related Financial Risk Management for Large Financial Institutions, which will take effect in early 2023, as well as the agency's support for the FRB's climate scenario analysis pilot.

"Climate-related scenario analyses should be designed and used by institutions to build knowledge and capabilities in climate-related financial risk management, as well as to better understand gaps in methodologies and data," the FDIC stated.

The FDIC's Statement of Principles provides a framework for the safe and sound management of financial institutions' exposures to climate-related financial risks, in line with existing FDIC rules and guidance. However, the FDIC has also proposed a climate-related disclosure form for companies seeking insurance. This suggests that the requirement to be aware of and disclose climate-related risks is imminent, meaning that all banks will soon need to implement reporting processes or potentially risk losing or being unable to obtain FDIC insurance.

National Association of Insurance Commissioners (NAIC)

In April 2022, state insurance regulators adopted a new standard to increase transparency around climate-related risks and introduce new disclosure requirements for providers. As of November 2022, a significant number of insurance companies must ensure that their reports on climate-related risks comply with rules set by the international Task Force on Climate-Related Financial Disclosures (TCFD).

According to an official press release from the NAIC, the move "puts U.S. state insurance regulators at the forefront of climate risk disclosure to protect consumers." The development also extends the influence of the Task Force on regulators worldwide, as a growing number of U.S. state commissioners join insurance regulators in France, Switzerland, and the U.K. in requiring TCFD-aligned reports.

Fifteen key states, representing around 80% of the U.S. insurance market, will enforce the new standard on insurance providers licensed in their jurisdictions this year. To remain compliant, insurance companies operating in these states will need to respond to the [NAIC's annual Climate Risk Disclosure Survey], which has been updated to align with TCFD reporting requirements. While only 28 companies in the U.S. produced TCFD-compliant reports last year, the NAIC expects this number to rise "to nearly 400 insurance companies and groups as a result of the [new] consensus."

European Financial Reporting Advisory Group (EFRAG)

In November 2022, the European Parliament announced the adoption of the Corporate Sustainability Reporting Directive (CSRD), which will require companies to report on environmental, social, and governance (ESG) issues using a common framework called the European Sustainability Reporting Standards (ESRS). The ESRS will cover 12 different topics: five on environmental sustainability (ESRS E1-E5), four on social issues (ESRS S1-S4), and three on governance (ESRS G1-G2).

Environmental standards - Climate change, pollution, water & marine resources, biodiversity & ecosystems, and resources & circular economy (ESRS E1-E5)

Social standards - Own company's workforce, workers in the value chain, affected communities, and customers & end users (ESRS S1-S4)

Governance standards - Governance, risk management & internal control, and business conduct (ESRS G1-G2)

The ESRS will require companies to report on their greenhouse gas emissions (Scope 1-3) and to align their sustainability metrics with the Task Force on Climate-related Financial Disclosures (TCFD) and the International Sustainability Standards Board (ISSB). It will also require companies to provide a high-level explanation of how they plan to adjust their operations and strategy in accordance with the Paris agreement. The ESRS requires that the reported sustainability information be independently audited.

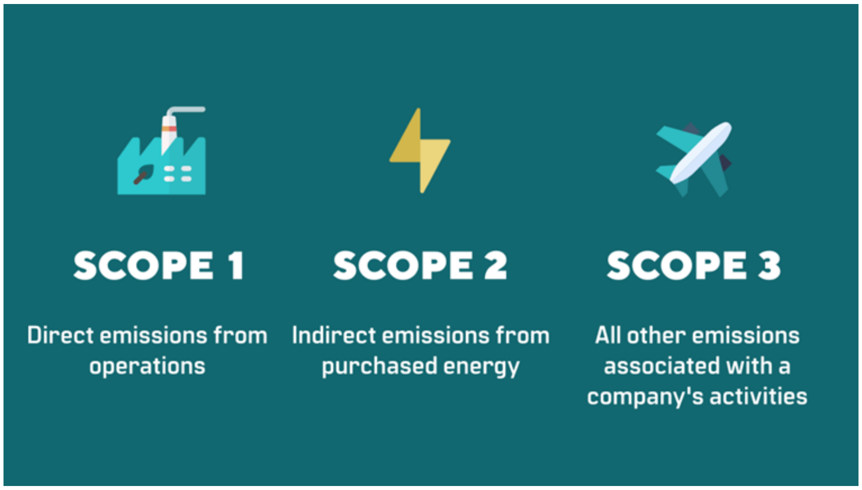

Figure 1: Definitions of Scope 1,2, and 3 Greenhouse Gas Emissions

The ESRS will apply to a wide range of EU and some non-EU based companies, expanding the number of organizations required to submit sustainability disclosures from around 12,000 to 50,000. Entities subject to ESRS reporting and auditing requirements will include:

Large companies - EU companies (or non-EU companies operating within the EU) that meet at least two of the following three criteria: 1) 250 or more employees, 2) net revenue exceeding €40 million, 3) total assets exceeding €20 million.

Listed EU companies - EU companies listed on public European exchanges, including small and medium sized businesses (SMEs).

Non-EU parent companies - Companies not established in the EU but which hold securities listed on EU-regulated markets AND maintain a combined group turnover in the EU exceeding €150 million.

Organizations will have to begin reporting under the new standards at different times, depending on the size and classification of the business. Those already required to report under the Non-Financial Reporting Directive (NFRD) will need to comply with the ESRS by 2024, while large entities not currently required to report under the NFRD will have to start in 2025. Listed small and medium-sized enterprises (SMEs) and small credit institutions will have to begin in 2026. Further guidance and official reporting deadlines will be released when the ESRS is finalized in June 2023. Companies that will be required to report under the ESRS should start implementing a compliance strategy as soon as possible, including clarifying their reporting requirements and streamlining the collection, organization, and distribution of all relevant ESG-related data.

Conclusion

The future of mandatory reporting requirements for Environmental, Social, and Governance (ESG) metrics, particularly in climate reporting, is becoming increasingly clear. Companies around the world are facing growing pressure from investors, consumers, and regulators to demonstrate their commitment to sustainability and to transparently disclose their impact on the environment and society. In response, we can expect to see mandatory reporting requirements for ESG metrics become more widespread in the coming years, with a particular focus on climate-related issues. In 2023, it is likely that some mandatory reporting requirements on ESG performance will be introduced to meet the expectations of stakeholders. This will require businesses to invest in understanding and managing their ESG risks and impacts, as well as developing strategies for continuous improvement.

While compliance with ESG frameworks is certainly an important reason for companies to start reporting on their environmental, social, and governance (ESG) performance, it is not the only reason. By demonstrating a commitment to sustainability and transparency through ESG reporting, organizations can also avoid the risk of losing potential financing options and insurance coverage. As more and more banks and investors prioritize sustainable investment, those companies that are unable to provide robust ESG reporting may find themselves missing out on capital. Therefore, it is important for organizations to start ESG reporting not only to meet regulatory requirements, but also to ensure that they are not left behind in the increasingly competitive landscape of sustainable finance.

For some companies, the process of establishing effective ESG reporting systems and processes may be a significant challenge, as it will involve a steep learning curve and the implementation of new systems for collecting, analyzing, and reporting on relevant data points. The topic of sustainability and climate risk management can be complex and multifaceted, and it may take time for companies to establish effective processes for identifying, measuring, and managing these issues. However, proactive preparation is crucial for avoiding negative impacts on financing, investment, and reputation. Companies that fail to prepare for mandatory ESG and climate reporting requirements may find themselves at a competitive disadvantage, as investors and other stakeholders increasingly favor those that are able to demonstrate their commitment to sustainability and transparency.

To be well-positioned when mandatory reporting requirements come into effect, businesses should start preparing now. This may involve seeking advice and guidance from experts in the field, collaborating with industry peers, and investing in the necessary systems and processes for collecting and reporting on ESG data. By taking these steps, companies can ensure that they are prepared for the eventual implementation of mandatory ESG and climate reporting requirements and are able to demonstrate their commitment to sustainability and transparency to their stakeholders.

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Environmental, Social & Governance (ESG) metrics are rapidly ascending in importance for all capital market participants. Companies monitoring ESG factors tend to be more vigilant on improving overall corporate governance, while increasing profitability and mitigating risk.

Focusing on risk oversight and mitigation strategies, advocating for cultural diversity and inclusion, and being a responsible corporate citizen creates a positive environment for employees and aligns the interests of all stakeholders.

Combining MZ Group’s consulting expertise with proprietary software capabilities helps crystallize each of these important components into one complete ESG solution that enables issuers to report ESG metrics in ways that resonate with capital markets participants.

ESGiQ is a user-friendly and interactive software platform designed specifically to customize ESG reporting for private and public companies, as well as ESG focused funds. ESG iQ is the only solution that generates a cross-sectional analysis incorporating Environmental, Social & Governance protocols, with the flexibility to adopt multiple standards.

ESG Consult empowers private and public clients to obtain greater insight into ESG best practices,while preparing them to track, monitor and properly report their material ESG factors to various stakeholders, rating agencies and financial media.

Please visit www.esgiq.mzgroup.us or email esg@mzgroup.us
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