Institute Briefing

Connecting ESG, Capital Markets, and CFOs

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The SustainAbility Institute by ERM

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Foreword

ESG risks and opportunities have entered the mainstream and become inextricably linked to corporate strategy and business outcomes. Faced with this, companies have an opportunity to position themselves to act on the challenges and opportunities presented and to turn them into competitive advantage. Many of these challenges and opportunities are landing in corporate finance, often on the CFO's desk.

Proactive business response to ESG risks and opportunities has the potential to protect and maximize the top-line by being more aligned with customer expectations, increasing innovation, reducing operating costs, and lowering cost of capital via participation in sustainable finance. Facing up to these challenges will also better position companies to tell their ESG stories more authentically – creating narratives which can be built upon to help meet emerging regulations.

This report draws on insights from ERM's 'boots to boardroom' ESG expertise and experience working with clients across a breadth of industries, as well as interviews conducted with company CFOs, treasurers, finance teams, lenders, and investors. It explores how ESG considerations are shaping the actions of companies – in particular, the actions of CFOs and finance teams in response to shifts in the capital markets. It sets out a blueprint for effectively navigating and thriving in this environment by highlighting four areas that will be critical for CFOs and finance functions to prioritize.

As CFOs and finance team leaders, we are well placed to harmonize the business implications of ESG risks and opportunities with corporate strategy, and to manage financial and ESG performance, data quality, and reporting in an integrated manner. Facing up to the changing cost of capital, getting ahead of the data and reporting requirements associated with new regulations, and ensuring that our companies have robust risk and control processes will ensure more resilient and healthy businesses going forward. In my numerous roles as CFO of publicly listed and privately owned global businesses, I have found this approach to be particularly effective, and I hope you find this report useful as you plot your own ESG course.

Simon Crowe
CFO
ERM

Executive Summary

This report explores the evolving relationship between ESG, capital markets, and corporate finance. It argues that CFOs and corporate finance teams will play a critical role in integrating ESG risks and opportunities into corporate strategy and operations.

By proactively responding to ESG risks and opportunities and improving ESG performance, CFOs have an opportunity to gain competitive advantage and capitalize on a broad range of new sustainable finance instruments. Sustainability-linked bonds and sustainability-linked loans have experienced exponential growth in recent years, and their uptake is expected to continue to expand at a rapid pace.

This report draws on findings from interviews with more than a dozen CFOs, investors, and lenders as well as insights from extensive ERM expertise. We explore four areas that CFOs and finance teams should prioritize and provide actionable recommendations:

1. **Leverage a structured framework to identify material ESG risks and opportunities:**

- Leverage frameworks and tools including TCFD, SASB, GRI, and <IR> to identify material ESG risks and opportunities.
- Develop scenario analyses for climate-related financial risks and opportunities and use them to inform financial planning.
- Advocate for your company to produce a TCFD report and lead in this effort.

2. **Integrate material ESG risks and opportunities into corporate strategy:**

- Manage material ESG issue performance measurement and reporting with the same analytical rigor and controls as financial reporting.
- Integrate ESG analytics into the company's financial reporting infrastructure.
- Digitize integrated (financial and ESG) data aggregation and reporting.

3. **Use ESG performance to be better positioned to access sustainable finance:**

- Develop your company's understanding of sustainable financial products and identify those that are best aligned with your company's needs.
- Leverage your company's ESG story and performance into your financing strategy and communication plans.
- Engage lenders to discuss new sustainable finance options.

4. **Ensure comprehensive disclosure and reporting that meets the needs of all stakeholders:**

- Advocate for and lead the integration of financial and non-financial reporting.
- Apply best practice reporting frameworks and develop an ESG reporting baseline that can be built upon when regulations are introduced.
- Maintain a dialogue with your investors and ESG raters and rankers.
- Engage with regulators and standard setters on emerging requirements.

Introduction

As awareness about the role of business in addressing the climate crisis, inequality, biodiversity decline, and other critical issues grows, ESG risks and opportunities have entered the mainstream and become inextricably linked to corporate strategy and financial outcomes. Companies have an opportunity to position themselves to face the challenges and opportunities presented and to turn them to competitive advantage – and finance has a critical role to play.

The unfolding climate crisis has reached unprecedented levels of urgency, making it imperative for business, government, and society to act to keep temperatures from reaching even more dangerous levels. Calls and momentum for climate action have grown exponentially in the lead-up to this year's United Nations Climate Change Conference (COP26), reinforced by the stark messages in the Intergovernmental Panel on Climate Change's *Sixth Assessment Report*, published in August 2021.[1]

At the same time, the COVID-19 crisis has exacerbated and highlighted inequalities worldwide, underscoring the need to address disparities in wealth and access to healthcare in particular. Awareness about other critical issues such as biodiversity decline, gender inequality, and human rights violations has also been on the rise.

As attention to Environmental, Social, and Governance (ESG) issues grows, so does recognition by business of their direct and indirect financial impacts and the need for companies to understand and address expectations of stakeholders beyond shareholders. ESG risks and opportunities have entered the mainstream, becoming inextricably linked to business strategy and a core part of good business management.

Growing acceptance of the importance of ESG issues is due in large part to more clearly understood linkages between ESG and financial performance. For example, environmentally and socially conscious consumer behavior is affecting sourcing and the production of goods and services, with direct impact on costs and bottom-line. Similarly, more employees are basing career choices on the ESG performance of employers, which is impacting companies' ability to attract and retain talent.[2] And, as the defining environmental issue of our times, responding to climate change has emerged as a key driver of core business strategy for many companies.

In the capital markets, as financial institutions are committing to net zero portfolios, investors are incorporating ESG considerations in investment decisions and directing capital towards sectors and companies with stronger ESG credentials. Lenders are also factoring ESG performance and climate risk into lending decisions and debt pricing, both as part of enterprise risk management and as a means of innovating product offerings such as sustainability-linked loans. In conjunction with this activity, there is a growing ecosystem of ESG raters and rankers providing analyses of companies' ESG performance. All of this is directly affecting companies' ability to access capital and its cost.

With ESG becoming central to corporate strategy and performance management, in their role as 'chief performance officers', Chief Financial Officers (CFOs) find themselves at the heart of this transition. Identifying major ESG risks and opportunities and understanding their linkage with financial performance is critical, as is the definition and management of related key performance indicators (KPIs). With increased use of and expectations for internal and external ESG reporting and disclosure, CFOs have an important role to play in ensuring that KPIs and related data are managed to the levels of quality expected by investors and other stakeholders.

Additionally, in their roles managing cashflows and financing the business, CFOs need to understand emerging sustainable finance products and use their companies' demonstrable ESG performance to optimize access to and cost of capital.

This report draws on insights from ERM's 'boots to boardroom' ESG capabilities and experience working with clients across a breadth of industries. It also incorporates insights from interviews conducted with CFOs, treasurers, lenders, and investors designed to explore how ESG considerations are shaping the actions of financial markets and companies and what these changes mean for corporate finance functions. Given the attention the climate crisis is now receiving across companies, their customers, financial institutions, regulators, and other stakeholders, examples of climate-related financial risks and opportunities are prominently featured in this report. We note other ESG issues can present similar or greater financial consequence to some companies than climate change and the transition to a low carbon economy. At a macro level, biodiversity, human rights, water scarcity, etc. continue to rise in importance and are subject to both policy intervention and increasing societal expectations.

Connecting ESG, Capital Markets, and CFOs explores how ESG factors are impacting corporate performance and financial market activities. This report argues that CFOs have particularly critical roles to play in four areas: Leveraging a structured framework to identify material ESG risks and opportunities; Integrating material ESG risks and opportunities into corporate strategy; Using ESG performance to better position companies to access sustainable finance, and; Ensuring comprehensive disclosure and reporting. By focusing on these four areas, CFOs and finance teams will help position their companies to thrive in an economy where ESG is becoming indisputably linked with long-term success.

Setting the Stage: ESG Performance and Access to Capital

As the linkage between ESG and financial performance becomes clearer, and as a growing number of investors and lenders integrate ESG considerations into their financing decisions, availability and cost of capital are increasingly tied to a company's ESG performance.

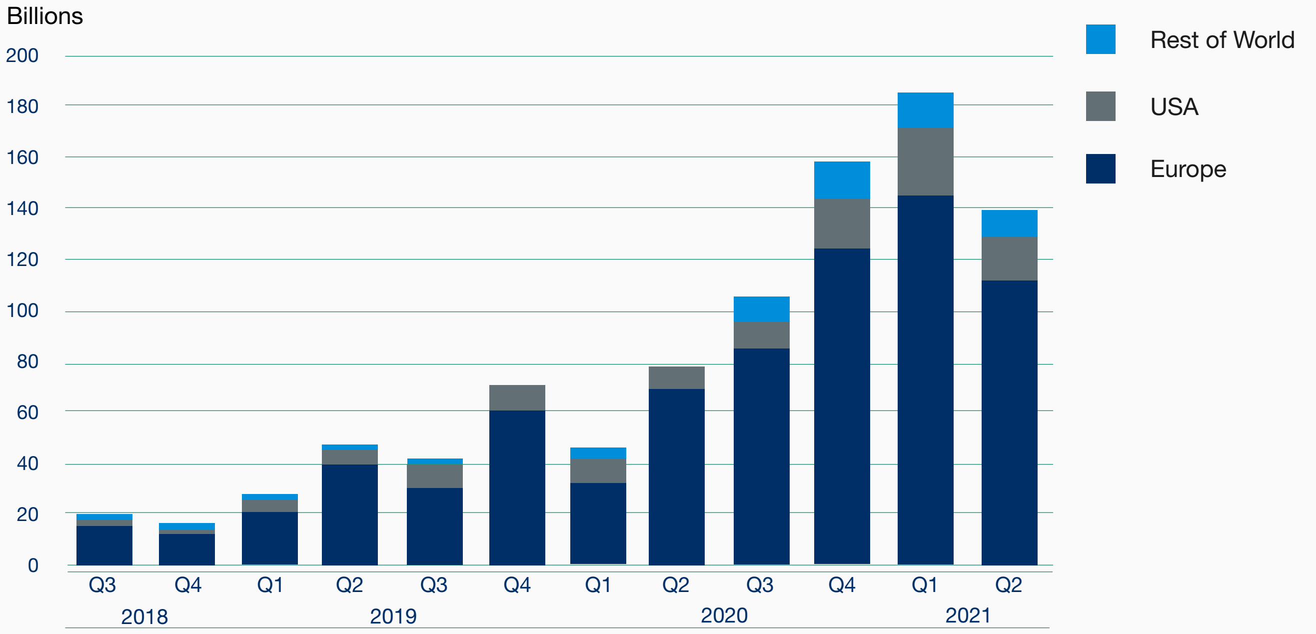
The application of ESG factors by the finance sector as a means to assess the viability of potential investments and debt issuance has accelerated significantly. According to HSBC's *Sustainable Financing and Investing Survey 2021*, 51 percent of issuers and investors (up from 39 percent last year and a three-year high) say they care about environmental and social issues because paying attention to them can improve returns or reduce risks.[3] This is visible in the record inflow of capital into ESG-themed funds and a growing number of banks setting trillion-dollar goals to finance more sustainable activities such as accelerating the transition to a low carbon economy or advancing the UN Sustainable Development Goals (SDGs). According to Morningstar, ESG-themed funds are now estimated to be worth $1.7 trillion globally.[4] Acceleration in sustainable investing is evident in all regions of the world and is most pronounced in Europe (see Chart 1).

ESG is also a growing focus for private equity. According to ERM's 2020 survey *Eyes on the Prize: Unlocking the ESG Premium in Private Markets*, 86 percent of polled private equity investors now have access to dedicated ESG teams when making investment decisions.[5]

The trend toward integration of ESG in investment decisions in both public and private markets is expected to continue to gather momentum, with Deutsche Bank estimating that 95 percent of all investment decisions will incorporate ESG factors by 2035.[6] Echoing this trend, Craig Larson, Partner and Head of Investor Relations at KKR noted that ESG topics come up in about 90 percent of the private equity firm's meetings with investors, a major change from previous years.

The global lending market is also undergoing a major transformation as financial institutions pivot their portfolios to align with net zero commitments. For instance, as part of its efforts to align financing activities with the Paris Agreement, JP Morgan Chase (JPMC) has set 2030 carbon intensity targets for the oil & gas, electric power, and auto manufacturing sectors. JPMC investments in these and other sectors will be guided by the Carbon Compass methodology, co-developed with ERM (see Case Study 1). As Ramaswamy Variankaval, Global Head of Carbon Transition Center at JPMC noted, "We engage with our clients to share our views on where the world is going in relation to the low carbon transition. We believe that all capital providers are going to look for climate-related data, just like we do with our Carbon Compass methodology, and it's in clients' best interest to share it so that we can collaborate on achieving our collective sustainability goals."

Chart 1: Capital Flows into Sustainable Funds 2018-2020 (US$)



Capital directed to ESG-themed funds has seen a rapid acceleration since 2019, with European funds attracting most of the new capital. Source: Morningstar.[7]

Case Study 1: JPMC's Paris-aligned Carbon Compass Methodology

In 2021, JPMC committed to align its client financing with the climate goals of the Paris Agreement by setting sector-specific, portfolio-level reduction targets. To accomplish this alignment, JPMC and ERM co-developed the bank's Carbon Compass methodology, a practical and future-ready approach that reflects leading thinking on Paris alignment.

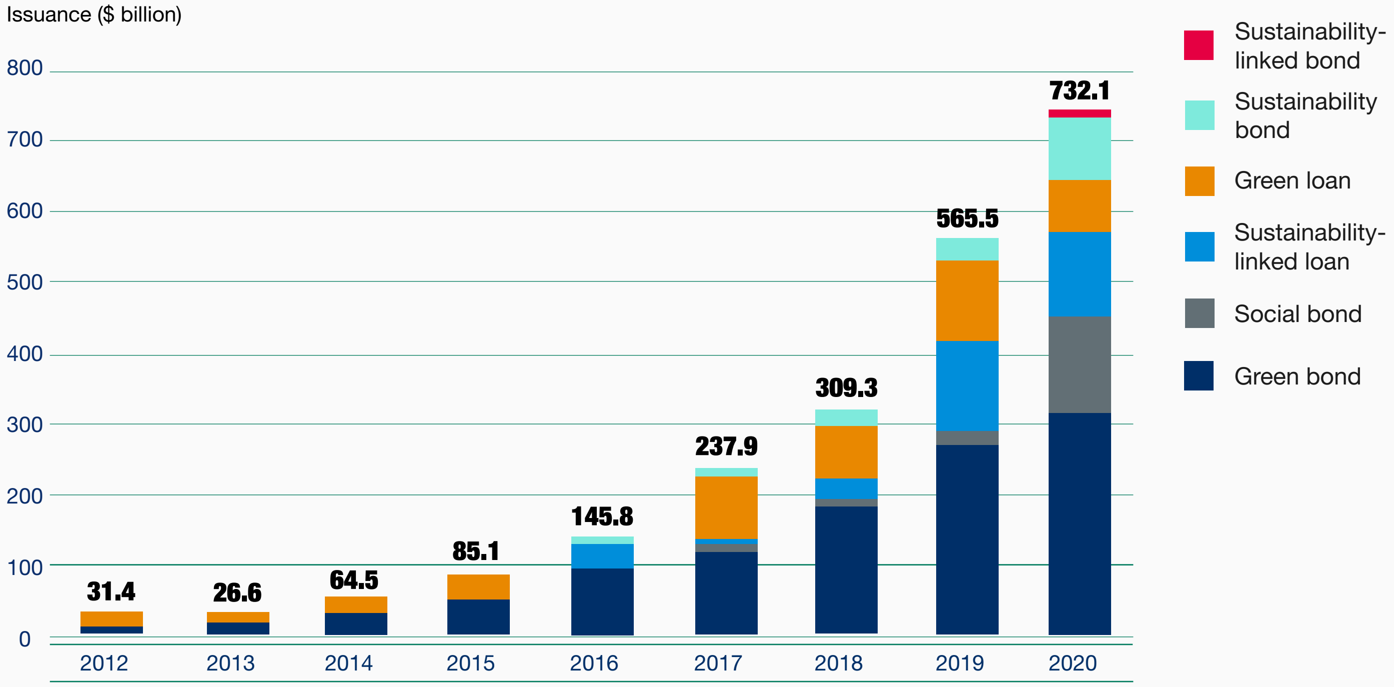
The Carbon Compass methodology enables JPMC to evaluate the Paris alignment of their global financing portfolio using a portfolio-weighted average of emissions performance for all of their clients in each sector portfolio. While the initial focus of Carbon Compass is the oil & gas, electric power, and auto manufacturing sectors, JPMC plans to expand this to address additional sectors.

Source: JPMC Carbon Compass Methodology[8]

To enable this change, JPMC has committed to finance and facilitate more than $2.5 trillion over 10 years to advance long-term solutions that address climate change and contribute to sustainable development.[9] As noted by Bloomberg, 13 percent of JPMC's bond underwriting business in 2021 has come from ESG-related debt compared to five percent last year.[10]

Since the issuance of the first green bond by the World Bank in 2008,[11] sustainable finance has experienced rapid growth, measured both by a growing volume and expanding range of products on offer. Sustainable debt issuance (including various types of loans and bonds – see Chart 2) reached $732.1 billion in 2020, the largest one-year volume on record.[12] According to Moody's, the sustainable bond market alone (which represents green, social, and sustainability-linked bonds) will expand by more than 59 percent in 2021 to reach $850 billion, accounting for eight to 10 percent of all global debt issuance.[13] Similarly, the volume of sustainability-linked loans also continues to expand rapidly, nearly doubling globally in the first six months of 2021 as issuance reached $350 billion versus $197 billion in the first half of 2020.[14]

Chart 2: Growth in Sustainable Debt Issuance 2012-2020 (US$)



Annual sustainable debt issuance grew from $31.4 billion to $732.1 billion over the period 2021-2020. Source: BloombergNEF, Bloomberg LP[15]

Box 1: Sustainable Financial Instruments

Green Loan: A loan where the proceeds must be allocated specifically to environmental projects (e.g., renewable energy developments or energy efficiency improvements).[16]

Sustainability-linked Loan: A loan where the interest rate is linked to the achievement of a sustainability objective (e.g., a GHG emissions reduction target or a diversity and inclusion target). If the objective is achieved, the borrower's interest rate is lowered. In contrast to green loans, the proceeds of a sustainability-linked loan do not have to be used for environmental projects.[16]

Green Bond: A bond where the proceeds must be used to finance environmental projects (e.g., clean transportation options or wastewater management solutions).[17]

Social Bond: A bond where the proceeds must be used to finance social projects (e.g., affordable housing developments or essential service provisions).[17]

Sustainability-linked Bond: A bond that is linked to the achievement of a sustainability objective (e.g., recordable injury target or energy reduction target). Progress made toward the objective will result in a decrease in the bond's coupon or vice versa if progress is not made. Like sustainability-linked loans, the proceeds of a sustainability-linked bond do not have to be used for environmental projects.[17]

"Five years ago, we were rarely asked about ESG issues. Now, it comes up at about 90 percent of our meetings."

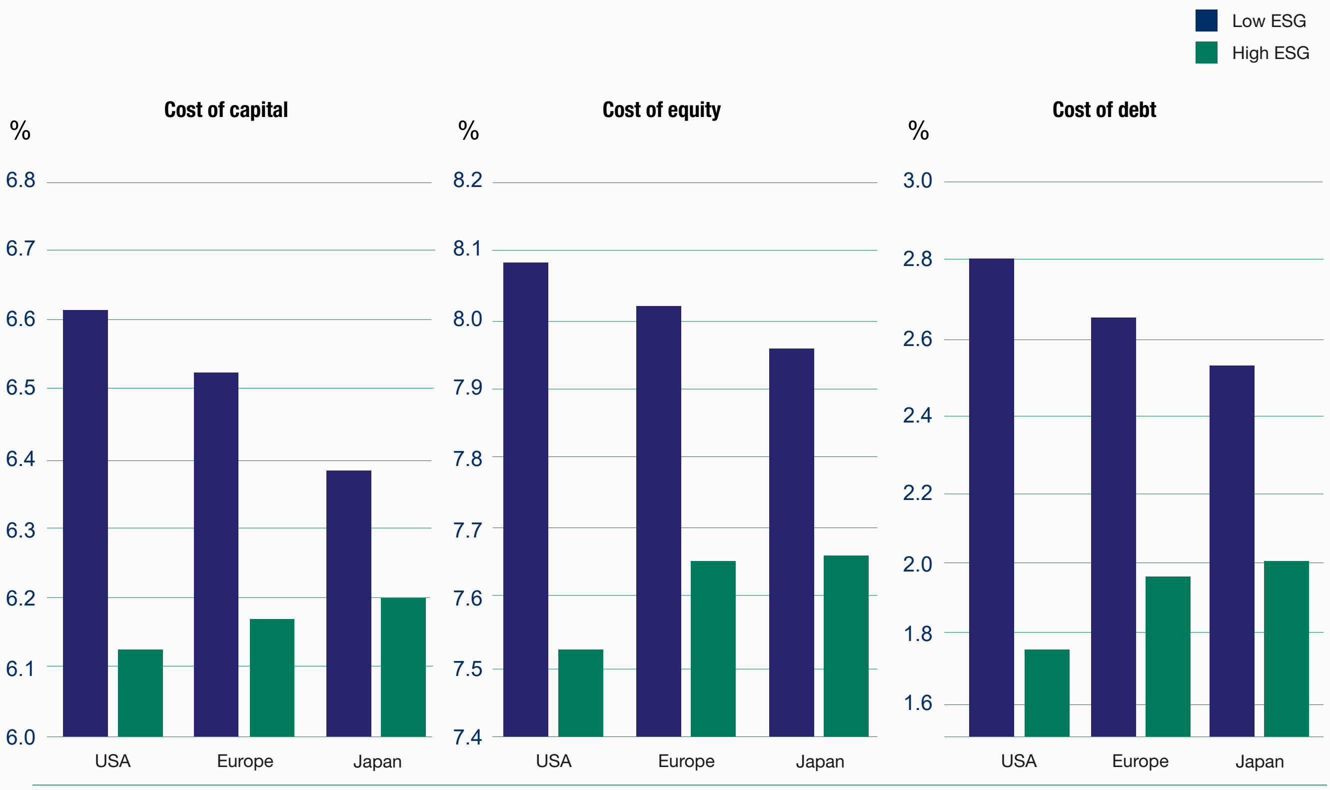
- Craig Larson, Partner and Head of Investor Relations, KKR

Sustainable finance instruments offer companies an opportunity to fund specific sustainability or low carbon transition initiatives (e.g., green bonds) or to provide funding for company operations (e.g., sustainability-linked loans). Beyond providing access to capital, such instruments are increasingly delivering a cost advantage. For instance, some public and private lenders are willing to pay a premium ('greenium') on green bond prices, making them economically advantageous to traditional bonds. The Climate Bond Initiative reported that order books for green bonds exceeded non-green bonds in both the U.S. and Europe during 2020.[18] This indicates a greater stickiness of orders and strong investor support for ESG elements. Similarly, in the case of sustainability-linked loans, the borrower is rewarded with a lower interest rate if they meet pre-agreed sustainability targets.

The connection between ESG performance and a lower cost of capital is supported by emerging data. For instance, in 2020 MSCI conducted a study to evaluate how company ESG performance impacted access to capital and debt. It found that companies with higher ESG ratings tended to have lower cost of capital. This was true for companies in the U.S., Europe, and Japan, with the association in the U.S. being the strongest (see Chart 3).[19]

The volume and range of sustainable financing products have experienced extraordinary growth. CFOs interviewed for this report indicated that many companies have yet to fully embrace these new financing structures. As more companies enter the space, both transaction volumes and 'greeniums' are expected to continue to increase.

Chart 3: Costs of Capital, Equity, and Debt Compared to ESG Performance



The costs of capital, equity, and debt compared to MSCI ESG Ratings performance ranging from low ESG performance to high ESG performance for companies in the U.S., Europe, and Japan. Source: MSCI [20]

The CFO Response: Four Areas for Action

A business-led response to ESG issues has the potential to maximize the top-line, reduce operating costs, and improve access to capital. CFOs and finance teams are well placed to integrate the business implications of ESG risks and opportunities into corporate strategy, and to manage financial and ESG performance, data quality, and reporting in an integrated manner.

As research and interviews for this report indicate, an increasing number of CFOs recognize the importance of shaping their organization's strategic response to ESG risks and opportunities and effectively managing data and reporting requirements. As Hilary Maxson, SVP and Group CFO of Schneider Electric noted, "You can only drive medium and long-term value – and manage risks – with the right balance of resource and time allocation to good ESG practices."

"With ESG going mainstream, CFOs have a new role to play in its management. They run their company's risk assessments and are responsible for corporate disclosures and engaging capital markets."

- Peter Bakker, President and CEO of the World Business Council for Sustainable Development (WBCSD)

As the importance of ESG continues to grow and the low carbon transition accelerates, we argue that CFOs and finance functions have critical roles to play in four key areas in particular:

1. Leveraging a structured framework to identify material ESG risks and opportunities.

2. Integrating material ESG risks and opportunities into corporate strategy.

3. Using ESG performance to be better positioned to access sustainable finance.

4. Ensuring comprehensive disclosure and reporting that meets the needs of all stakeholders.

THE CFO RESPONSE: FOUR AREAS FOR ACTION

LEVERAGING A STRUCTURED FRAMEWORK TO IDENTIFY MATERIAL ESG RISKS AND OPPORTUNITIES

- Leverage frameworks and tools like TCFD, SASB, GRI, <IR>, the Natural Capital Protocol, and the Social & Human Capital Protocol to identify material ESG risks and opportunities and determine their impact on financial performance.
- Develop scenario analyses for climate-related financial risks and opportunities and use them to inform financial planning and strategy.
- If your company has not published a TCFD report, advocate for one to be produced and lead in this effort.

INTEGRATING MATERIAL ESG RISKS AND OPPORTUNITIES INTO CORPORATE STRATEGY

- Manage material ESG issue performance measurement and reporting with the same analytical rigor, data quality, governance, and controls as financial reporting.
- Integrate ESG analytics and reporting into your company's financial reporting infrastructure.
- Digitize integrated (financial and ESG) data aggregation and reporting.

USING ESG PERFORMANCE TO BE BETTER POSITIONED TO ACCESS SUSTAINABLE FINANCE

- Develop your company's understanding of sustainable finance products and identify those that are best aligned with your company's needs.
- Leverage your company's ESG story and performance into your financing strategy and communication plans.
- Engage lenders regarding opportunities to replace existing financing with sustainable finance products and discuss new financing options.

ENSURING COMPREHENSIVE DISCLOSURE AND REPORTING THAT MEETS THE NEEDS OF ALL STAKE-HOLDERS

- Advocate for and lead integration of financial and non-financial reporting.
- Apply best practice reporting frameworks (TCFD, GRI, SASB, CDP, GHG Protocol, etc.) and, in the absence of specific reporting requirements, develop an ESG reporting baseline that can be built upon when regulations are introduced.
- Maintain a dialogue with your investors and the ESG raters and rankers that are most important to your company.
- Engage with regulators and standard setters on emerging requirements.

1. Leveraging a Structured Framework To Identify Material ESG Risks and Opportunities

Identifying material ESG risks and opportunities and determining their potential financial impacts are foundational steps for companies. In doing this, companies should consider leveraging an existing framework as a starting point. Adoption of a structured framework to identify and respond to ESG risks and opportunities brings more analytic rigor into strategic responses and business decision-making.

In the climate space, the framework set by the Task Force on Climate-related Financial Disclosures (TCFD) has become core to corporate response. Adopted in 2017, the TCFD provides a structured approach to identifying climate-related financial risks and opportunities. Its uptake has accelerated rapidly; in 2020 alone, TCFD adoption grew by 99 percent. Currently, over 2,600 companies with a market cap of $25 trillion and assets of $194 trillion report in a TCFD-aligned manner.[21]

A growing number of companies are conducting climate scenario analyses (a requirement for TCFD-aligned reporting). According to CDP, 54 percent of companies responding to their 2020 climate change questionnaire conducted such an analysis.[22] For instance, in its annual integrated report's TCFD section, Unilever discusses the climate scenario analysis it has undertaken. The analysis included two main steps: determining business and financial impacts under 2°C and 4°C warming scenarios; and forecasting future agricultural yields for their three core agricultural commodities (see Case Study 2).

The critical role of the CFO in strategic planning, performance management, and financial reporting puts them at the centre of determining the financial impacts of climate change and ensuring their company's response is understood by capital markets and lenders. Chart 4 outlines types of climate change risks and opportunities that can present financial implications for companies. Transition risks such as policy (e.g., carbon pricing), technological shifts (e.g., investment in low carbon technologies), or market changes (e.g., growing consumer preferences for more sustainable products) can all have significant financial impacts on companies. Similarly, climate-related opportunities (e.g., energy efficient buildings or access to government subsidies for environmentally-friendly technologies) can also materially impact corporate revenues, expenditure, and the balance sheet.

Case Study 2: Unilever's Incorporation of Climate-related Financial Risks into Decision-making

Unilever highlights its climate scenario analysis-focused two-step evaluation process in its annual integrated report's TCFD section. In the first step, Unilever models the potential financial impact of temperatures reaching 2°C and 4°C by 2100. For each scenario, the company identifies likely material business impacts and related financial impacts in the year 2030. For example, under the 4°C scenario, chronic and acute water shortages are likely to limit the productivity of agricultural land in some areas, likely raising the prices Unilever will pay for certain product inputs. In the second step, Unilever forecasts future agricultural yields for their three core agricultural commodities using climate models, then determines the likely impact on prices and the estimated financial exposure that may result.

Source: Unilever Annual Reports and Accounts 2020[23]

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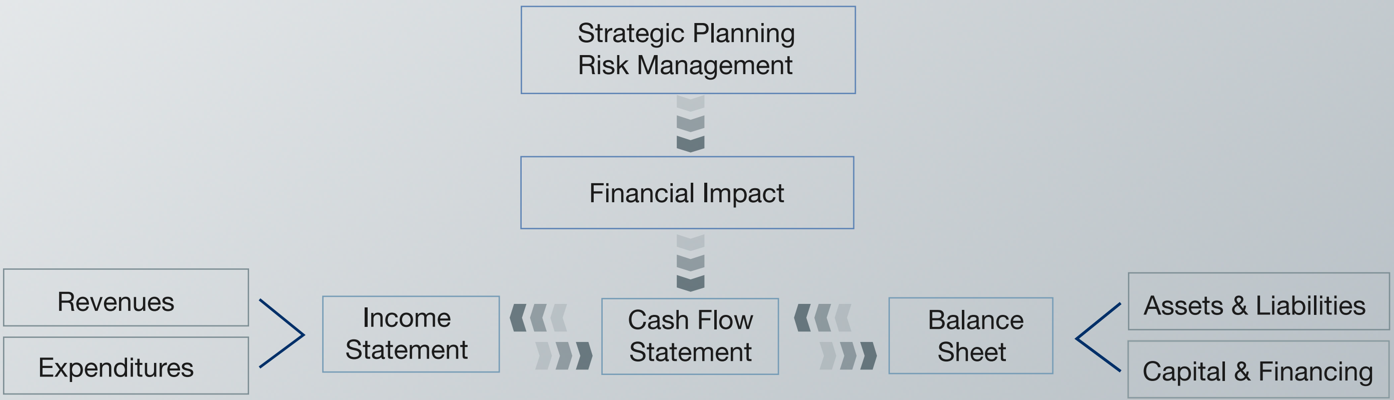
Chart 4: Climate Change Risks and Opportunities that May Have Financial Implications for Companies

RISKS	
Transition	**Policy and Legal** • Carbon pricing and reporting obligations. • Mandates on and regulation of existing products and services. • Exposure to litigation. **Technology** • Substitution of existing products and services with lower emissions options. • Unsuccessful investment in new technologies. **Market** • Changing customer behaviour. • Uncertainty in market signals. • Increased cost of raw materials. **Reputation** • Shift in consumer preferences. • Increased stakeholder concern / negative feedback. • Stigmatization of sector.
Physical	• Acute: Extreme weather events. • Chronic: Changing weather patterns and rising mean temperature and sea levels.

OPPORTUNITIES	
• Use of more efficient modes of transport and production and distribution processes. • Use of recycling. • Move to more efficient buildings. • Reduced water usage and consumption.	Resource Efficiency
• Use of lower-emission sources of energy. • Use of supportive policy incentives. • Use of technologies. • Participation in carbon markets.	Energy Source
• Development and/or expansion of low emission goods and services. • Development of climate adaptation and insurance risk solutions. • Development of new products or services through R&D and innovation.	Products & Services
• Access to new markets. • Use of public sector incentives. • Access to new assets and locations needing insurance coverage.	Markets
• Participation in renewable energy programs and adoption of energy-efficiency measures. • Resource substitutes / diversification.	Resilience



Examples of climate change risks and opportunities and their potential financial implications for companies.
Source: TCFD[24]

The use of the TCFD framework will become more widespread, especially as national governments and financial regulators mandate the evaluation and disclosure of climate-related financial impacts (as governments in the UK and New Zealand have done already). The content of TCFD disclosures is also increasingly incorporated into decision-making by investors. This makes TCFD's use by companies and their CFOs not only an essential step to enabling effective decision-making, but also in engaging and reassuring the capital markets.

In addition to the uptick in voluntary and mandatory use of the TCFD framework to assess and report on climate-related financial risks and opportunities, there is also a recognition of the need for a similarly rigorous approach for other ESG factors. For example, major financial institutions and multinational corporates have endorsed the launch of the new Taskforce on Nature-related Financial Disclosures (TNFD), which will support business in assessing emerging nature-related risks and opportunities. Leading companies also continue to leverage other established frameworks including the Sustainability Accounting Standards Board (SASB), the Global Reporting Initiative (GRI), the International Integrated Reporting Framework (<IR>), the Natural Capital Protocol, and the Social & Human Capital Protocol to identify, manage, and report on material ESG risks and opportunities.

Recommended Actions for CFOs and Finance Functions:

- Leverage frameworks and tools like TCFD, SASB, GRI, <IR>, the Natural Capital Protocol, and the Social & Human Capital Protocol to identify material ESG risks and opportunities and determine their impact on financial performance.
- Develop scenario analyses for climate-related financial risks and opportunities and use them to inform financial planning and strategy.
- If your company has not published a TCFD report, advocate for one to be produced and lead in this effort.

2. Integrating Material ESG Risks and Opportunities Into Corporate Strategy

Companies are increasingly integrating ESG risks and opportunities more deeply into corporate strategy.

According to Jessica Uhl, CFO of Shell, the low carbon transition is one of the major factors shaping the company's corporate strategy. "Energy transition is front and center in our strategy; it is the lens through which we run our company," says Uhl. The energy and wider economy transition is one of the main considerations that all CFOs and their teams need to integrate into planning and conducting financial operations.

Capital allocation is one way in which CFOs are finding themselves more deeply involved at the nexus between shaping corporate strategy and responding to the challenges posed by the low carbon transition and other ESG issues. By some estimates, achieving net zero emissions by the middle of the century will require $1 trillion to $2 trillion of investment annually, significant parts of which will need to come from companies.[25] In a recent survey of opinion leaders by Brunswick Group, 33 percent of respondents in the UK said that funding for clean technologies should primarily come from energy companies, while 27 percent said that investors should be leading this effort. In the U.S., the numbers were 32 percent for energy companies and 31 percent for investors.[26] In the context of biodiversity, annual investments of $350 billion in sustainable food processes and land-use practices could lead to closing the nature conservation investment gap, while also providing $4.5 trillion of market opportunities per annum.[27]

Even when the money comes from other sources, these flows will affect corporate plans and planning. According to Harald Wilhelm, CFO of Daimler AG, capital allocation is one of the key areas where CFOs can shape their company's approach to the net zero transition. For instance, Daimler recently decided to shift all its new drivetrain investments to electric car development platforms, a decision that will rest heavily on the finance team for its implementation.

CFOs also have roles to play in other important aspects of integrating ESG into corporate strategy. For instance, finance teams are key to determining the financial materiality of ESG topics. Whilst important to enable effective decision making, reporting on materiality processes and outcomes will become mandatory for most medium and large companies in the European Union (EU) after the Corporate Sustainability Reporting Directive (CSRD) takes effect.[28] Other markets are likely to follow soon. Frameworks and tools mentioned in the previous section including SASB and the Capital Coalition's Natural Capital Protocol and Social & Human Capital Protocol can help CFOs identify the financial impacts of ESG issues on their business and incorporate this information into their corporate strategies.

"The finance team has historically been the place to define value in financial terms, where you make decisions on how to allocate resources based on financial outcomes. What has changed is how carbon plays into the equation. The finance teams can no longer only work with financial outcomes; they now have to integrate carbon outcomes in our decision making, particularly when determining where to invest and grow our business."

- Jessica Uhl, CFO, Shell

"What are the main actions that CFOs can take? Capital allocation is one of the key areas. Daimler made a decision to put new drivetrain investments only into electric car development platforms. No dollars into new combustion platforms – full stop. While that puts quite a lot of scrutiny on our organization, it fosters change and forces the company to address what matters."

- Harald Wilhelm, CFO, Daimler AB

> **"Every bank or financial service provider will likely price carbon in some way in the future. Most forward thinking companies do not want to wait to account for a carbon price until after the broader economy sets one."**
> *- Ramaswamy Variankaval, Global Head of Carbon Transition Center, JPMC*

Another input into the development of net zero strategies, related capital investment, and organizational change management programs is long-term scenario planning and forecasting uncertainties related to the impact of climate change. According to Kurt Kuehn, SASB Standards Board Member and former CFO of UPS: "We do not know what will happen with issues like climate change, so companies need to plan for different scenarios. The CFO's role is to understand the impact of different scenarios on corporate value and to develop a plan to manage these potential outcomes."

Analytical rigor and data integrity are paramount to effective corporate strategy in the low carbon economy, especially as financial and ESG data become more deeply integrated. However, many organizations face challenges related to the quality of their performance data, partly because the internal controls for ESG KPIs fall short of those applied to financial metrics. Given the rising importance of ESG to future business performance, companies are developing and improving their internal controls.

CFOs and their teams have the mindset, capabilities, and operating infrastructure needed to make ESG data robust. Corporate finance functions also often have experience with digital solutions that automate the collection, aggregation, and reporting of financial data, positioning them to do the same for material ESG issues.

At Nissan, the finance team plays a critical role collecting and aggregating ESG data. "ESG data comes from various functions across our organization and gets aggregated and reviewed by the finance team. The key is making sure information is accurate. Our Investor Relations department (also within finance) then works with the Chief Sustainability Officer to produce our sustainability report," says Rakesh Kochhar, SVP, Group Treasurer & Global Sales Finance, Nissan.

Digitization will be one of the most important steps required to bring ESG data to the same level of completeness and accuracy as financial data. David Khani, CFO at U.S.-based energy company EQT notes that the digital transformation of data management systems has been key to accurately and effectively integrating ESG data collection from operating units across multiple locations and getting all the data onto one platform. "This has been critical to mitigating data and reporting risks thanks to the standardization, controls, and auditability that can be achieved in a digital environment," says Khani.

A plethora of ESG-specific digital reporting solutions becoming available have the potential to be integrated into existing reporting systems, and many of the large enterprise resource planning systems are also developing ESG modules. As ESG data is integrated, corporate finance functions are set to play a major role in increasing its accuracy and completeness.

Recommended Actions for CFOs and Finance Functions:

- Manage material ESG issue performance measurement and reporting with the same analytical rigor, data quality, governance, and controls as financial reporting.
- Integrate ESG analytics and reporting into your company's financial reporting infrastructure.
- Digitize integrated (financial and ESG) data aggregation and reporting.

3. Using ESG Performance To Be Better Positioned to Access Sustainable Finance

Companies that integrate climate and ESG risks and opportunities into their business strategies and which are effective at managing and demonstrating ESG performance can capitalize on opportunities to access sustainable finance products. As noted by Aaron Franklin, Head of Sustainable Finance for the Americas at Sumitomo Mitsui Banking Corporation, "Action is now needed beyond disclosure – the focus is on how a company is addressing risks and opportunities in innovative ways across ESG and climate change. Having a nice sustainability report does not in itself change the lending decision."

Based on recent trends and interviews with lenders conducted for this report, the volume of sustainable finance products can be expected to continue to grow. The range and diversity of such financial products will also further expand. For example, companies are experimenting with SDG-linked bonds, which are structured to incentivize the allocation of capital to address the Global Goals. Businesses are also testing innovative bond structures that link interest rates to greenhouse gas emissions targets or diversity & inclusion goals. According to Steffen Kram, Global Head of ESG Solutions at Santander Corporate & Investment Banking, another market innovation is sustainability-linked supply chain finance designed to help companies address Scope 3 emissions.

Beyond access to capital at more favourable terms, sustainable finance products offer several other advantages to companies. By using such instruments, companies can signal climate consciousness, reinforcing their brand and burnishing stakeholder relationships. They are also an effective means of raising capital to finance climate transition strategies such as the development of less carbon-intensive products or innovative service delivery models. Using sustainable finance products can help attract new types of investors, in particular those who are more climate or ESG conscious.

ERM has been working with many companies on sustainable finance, including green and sustainability-linked loans and bonds (see Case Study 3). ERM itself also recently took advantage of such instruments when amending and extending its own debt package. According to Simon Crowe, CFO of ERM, four ESG-related metrics were included in ERM's latest debt package in the categories of Climate Change, Health & Safety, People, and Society.

"Finance and accounting urgently need to build the ESG data infrastructure. Data needs to be consistent. This is the new reality of finance and accounting, and the changing external environment is a clarion call to action."

- Kurt Kuehn, SASB Standards Board Member, former CFO of UPS

Case Study 3: Liberty Tire Recycling Green Loan

ECP's acquisition of Liberty Tire Recycling in May 2021 involved a $410 million, seven-year green Term Loan B (TLB), which has been cited as being among the first U.S. green term loans outside of the renewable energy sector and the first green TLB in the U.S. leveraged loan market backing a buyout.[29] Liberty Tire Recycling's core business is sourcing, sorting, processing, and distributing used tires into multiple beneficial end use markets, each diverting used tires from landfills.

ERM provided a Second Party Opinion on the alignment of the assertions made by ECP with the core components of the Green Loan Principles issued by the Loan Market Association, Asia Pacific Loan Market Association, and Loan Syndications & Trading Association.[30]

Lenders interviewed for this report stressed how important it is for companies to seize emerging opportunities. Clearly identifying material ESG risks and opportunities and demonstrating strong ESG performance with the help of robust ESG data will be key to unlocking the benefits presented by sustainable finance instruments. Trafigura was among the first commodity trading companies to add ESG KPIs to their credit facility. The KPIs relate to reducing Scope 1 emissions, obtaining ISO certifications for the responsible sourcing of metals, and investment in 135MW of renewable energy projects. According to Christophe Salmon, Group CFO of Trafigura, “ESG is one of the most significant components of any investment committee decision. It is a prerequisite before entering the financial assessment and other financial KPIs.”

Whether by including ESG and climate risks and opportunities in conversations with lenders on debt refinancing, at investor events, or when evaluating how ESG and low carbon energy transition capital projects could be financed using new types of sustainability-linked debt instruments, CFOs have many opportunities to use ESG performance to improve their company’s access to finance at preferable rates.

Recommended Actions for CFOs and Finance Functions:

- Develop your company’s understanding of sustainable finance products and identify those that are best aligned with your company’s needs.
- Leverage your company’s ESG story and performance into your financing strategy and communication plans.
- Engage lenders regarding opportunities to replace existing financing with sustainable finance products and discuss new financing options.

4. Ensuring Comprehensive Disclosure and Reporting that Meets the Needs of All Stakeholders

CFOs are well-positioned to ensure their company's ESG reporting is comprehensive and aligned with financial reporting and strategy. Furthermore, they are particularly well placed to drive integrated reporting of financial and non-financial data. As Kurt Kuehn of the SASB Standards Board put it, "Now is the time for companies to use the same scrutiny as they use with their annual reporting on their ESG reporting."

Many companies are expanding ESG disclosures in their sustainability reports and annual reports to highlight how they are managing the impact ESG has on their business, as well as the impact their business has on ESG issues. ESG disclosures in corporate Proxy Statements are also increasingly common. According to Nasdaq, 92 percent of S&P 100 companies disclose ESG information in their Proxy Statements, with 70 percent including ESG highlights in their proxy opening letter to shareholders.[31]

While still far from common practice, integration of financial and non-financial reporting is increasing. According to Hilary Maxson of Schneider Electric: "We have already changed our external reporting to include both financial and ESG performance into one release. We are more and more seeing these as tied and are encouraging financial planning that combines both the right financial outcome as well as the right sustainability outcome."

CFOs whose companies are not yet publishing integrated reports are well placed to drive these initiatives and should prepare to do so by familiarizing themselves with the various organizations that define the space. Recently formed from the merger of SASB and the International Integrated Reporting Council, the Value Reporting Foundation produces resources such as the SASB standards and the <IR> Framework (which provides guidance centred on the six capitals of integrated reporting: Financial, Human, Intellectual, Manufactured, Natural, Social, and Relationship). The Capitals Coalition is another major player in the integrated reporting space. The Coalition's Natural Capital and Social & Human Capital protocols help organizations identify, measure, and value their impacts and dependencies associated with the capitals.

While growing ESG disclosure helps ensure investors have more access to ESG-related information, volume growth does not always mean improved quality and accuracy. The CFOs, investors, and lenders interviewed for this report overwhelmingly agree that lack of uniform ESG reporting standards is a major barrier standing in the way of ESG playing a greater role in shaping corporate strategy and further integration of ESG and financial data.

The absence of uniform and mandated requirements is the main reason why non-financial reporting is often presented in multiple formats and includes a broad range of different metrics. This can cause a multitude of difficulties, including for CFOs looking to demonstrate company ESG and climate performance to investors, lenders, and other stakeholders. As noted by EQT's David Khani, "The sheer scale of information generated and the lack of a common reporting structure make it difficult for investors and other interested parties to compare one company's ESG performance to another."

The landscape is further complicated by the growing number of third-party ESG ratings and rankings agencies, which deploy a multitude of information collection practices and scoring methodologies. Information from ESG ratings and rankings agencies is used by investors and lenders, making company performance on such ratings important for CFOs. The complexity of the ESG ratings and rankings landscape, lack of transparency in methodology, and the sheer volume of them was mentioned as a major obstacle by many of the CFOs, investors, and lenders interviewed for this report. Given this ESG ratings and rankings landscape, engaging on ESG topics with investors is particularly important, and this is something CFOs and their teams can support.

> **"When speaking with our shareholders on ESG, there is no consensus on a single rating. That's why we believe it is important to engage with investors on ESG topics and link corporate finance to sustainability performance."**
>
> *- Fernando Tennenbaum, CFO, Anheuser-Busch InBev*

The emergence of standardized reporting requirements and structures in several geographies has been a welcome development. For example, the European Union's (EU) Non-Financial Reporting Directive released in 2014 mandates publicly traded companies with more than 500 employees publish ESG information. In April 2021, the EU also adopted a Sustainable Finance Package, which includes a Corporate Sustainability Reporting Directive that will apply to all large and publicly traded companies (nearly 50,000 in total) and mandates more detailed non-financial reporting.[32] Furthermore, the EU Taxonomy[33] and the EU Sustainable Finance Disclosure Regulation[34] are beginning to influence the construct and design of investment fund strategies and company disclosures.

Momentum behind ESG reporting requirements is growing in the U.S. as well. In March 2021, the Securities and Exchange Commission (SEC) announced it was evaluating its disclosure rules "with an eye toward facilitating the disclosure of consistent, comparable, and reliable information on climate change" and asked for the public's input to support the evaluation.[35] In the U.S. Congress, the proposed CLEAN Future Act includes a requirement for the SEC to mandate climate disclosures within two years of the bill's passage, indicating appetite for reporting requirements outside of the executive branch.[36]

Because of the growing importance of ESG reporting and disclosure to corporate performance, CFOs have an important role to play in crafting and telling an authentic, convincing story around ESG performance and purpose and ensuring that the information disclosed is accurate and relevant.[37]

As with ESG data aggregation and analysis, ESG reporting and disclosure should not be left with the sustainability team to undertake alone. CFOs and finance teams should work with sustainability teams and others to integrate their company's financial story as it relates to ESG into their reporting portfolio. The finance team at EQT provides an example of what this looks like in action. "The finance team's data capabilities are readily transferable into the ESG space, and our finance team is working with other teams across the company to ensure that EQT's ESG reporting meets the same rigors as our financial reporting," says David Khani of EQT.

By integrating ESG and financial reporting, companies can improve ESG performance, strengthen data and disclosure quality, and enhance access to financing while reducing the cost of capital. CFOs are also establishing and joining a growing number of industry and professional networks to share and develop best practices and devise new approaches aimed at fostering innovative ESG reporting and strategy and strengthening the role of finance teams in this process (see Table 1).

While a lack of uniform standards presents a challenge, CFOs also have an important role to play in advocating for such measures and new regulations. According to Shell's Uhl: "There are many constituents that play a role in shaping ESG standards and reporting requirements – from the governments and regulators implementing sound policy to auditors evaluating the implications of the energy transition in a company's accounts. This is a whole new field that will require focus, diligence, and effort to make both positively impactful as well as practically possible."

"The finance team's data capabilities are readily transferable into the ESG space, and our finance team is working with other teams across the company to ensure that EQT's ESG reporting meets the same rigors as our financial reporting."

- David Khani, CFO, EQT

"The EU Sustainable Finance Disclosure Regulation is already proving to be a game-changer and disruptor as it coalesces capital around 'green' funds and increases transparency in the private markets."

- Alex Scott, Partner and ESG Committee Member, Pantheon Ventures

Table 1: Emerging ESG and Climate-focused Groups for CFOs

Organization	Description
Accounting for Sustainability	A CFO Leadership Network that develops guidance and resources directed to CFOs and finance teams on a breadth of relevant subjects including net zero and implementing sustainable finance frameworks.
UN Global Compact CFO Taskforce	A platform for CFOs to interact with the United Nations Global Compact to share ideas, develop new concepts and frameworks, and provide recommendations to unlock private capital and create a market for mainstream SDG investments.
CFO Network at the WBCSD	A network that helps shape the dialogue, work with investors, and gain access to the tools and resources needed to advance stakeholder capitalism.

Recommended Actions for CFOs and Finance Functions:

- Advocate for and lead integration of financial and non-financial reporting.
- Apply best practice reporting frameworks (TCFD, GRI, SASB, CDP, GHG Protocol, etc.) and, in the absence of specific reporting requirements, develop an ESG reporting baseline that can be built upon when regulations are introduced.
- Maintain a dialogue with your investors and the ESG raters and rankers that are most important to your company.
- Engage with regulators and standard setters on emerging requirements.

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Conclusion

Connecting ESG, Capital Markets, and CFOs has explored how ESG trends and innovation in sustainable finance are interconnected and the critical role that finance teams can play in a business-led response to ESG issues.

ESG transformation is a journey. To guide companies in this journey, we have outlined four areas of activity that CFOs and finance functions should prioritize. For each of these areas, using insights gained through our experience in working with clients and from interviews with CFOs, investors, and lenders, we have explored emerging challenges and the actions companies are taking to overcome them, embrace related opportunities, and seize competitive advantage.

While every company will have a different starting point and strategy, what is true for all is that delay will prove costly to business and society. It is essential to act now.

It is encouraging to see a growing number of companies taking steps to identify and integrate ESG risks and opportunities into their corporate strategy, and we believe that this trend will continue to grow. While focusing on what finance must do, this report also recognizes the role various enablers will play in this transformation including government policies, regulations, and reporting requirements.

ESG transformation is a journey for ERM as well, and we are integrating our recommendations into our own strategy. We know that our biggest impact is in supporting the private sector as it navigates this transition. We appreciate the opportunity to engage with you and would welcome feedback on how you are putting recommendations outlined in this report into practice and how to make our reports more useful and actionable.

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