HSBC Global Research

12 May 2022

ESG Matters

EU: A new benchmark for sustainability disclosure

Free to View
ESG - Europe

- A consultation for sustainability reporting standards has been launched by the EU – a major piece of the disclosure jigsaw
- The standards urge companies to align their business strategies with the EU's sustainable development plan
- We think the standards would set a high bar for sustainability disclosure and drive development of other frameworks globally

Polo Heung
Associate, ESG Research
The Hongkong and Shanghai Banking Corporation Limited

Wai-Shin Chan, CFA
Head, Climate Change Centre; Head, ESG Research
The Hongkong and Shanghai Banking Corporation Limited

Yaryna Kobel
Corporate Governance Analyst
HSBC Bank plc

Long-awaited standards: A year after the European Commission's adoption of the *Corporate Sustainability Reporting Directive (CSRD)*, the European Financial Reporting Advisory Group (EFRAG) has launched a consultation on mandatory reporting standards. All large and listed companies are expected to report their audited sustainability information in accordance with the proposed standards. We think the potential standards represent one of the most comprehensive disclosure requirements around the world, underpinning the EU's sustainability goals. In our view, they are likely to influence sustainability disclosure across different jurisdictions.

Delivering EU sustainability goals: With the interconnection between other EU sustainability initiatives like the EU Taxonomy and Emissions Trading System (ETS), we think the draft standards would support and complement the EU's sustainable development plans, particularly its climate and biodiversity strategies, as companies would be required to disclose their transition plans towards a biodiversity-positive and climate-neutral economy, along with a set of concrete metrics and targets.

Enhancing clarity: Under the principle of double materiality, companies would be required to produce forward-looking reports, highlighting the ***sustainability impacts*** of their operations and the ***financial impacts*** of sustainability issues. We believe these impacts are interrelated and the enhanced disclosures could facilitate the process of integrating ESG factors into investment decisions making and analysis.

Issues to watch: Climate-related disclosures are a focus of the draft standards. In addition to the recommendations of the Taskforce of Climate-related Financial Disclosure (TCFD), EFRAG proposes more rigorous and more finance-related requirements such as *locked-in emissions*, *value chain (scope 3) emissions* and potential liability derived from the EU ETS. The draft standards also embrace **biodiversity** disclosure by proposing measurable targets and metrics which would improve the tracking and monitoring of issues related to nature-based solutions. The potential disclosures also touch upon broader issues such as **gig workers, value chain management** and **corporate governance**. Besides the challenge for companies accurately reporting on such broad topics, we think it is a big step towards providing better sustainability disclosure for investors and other stakeholders.

This is a Free to View version of a report by the same title published on 12-May-22. Please contact your HSBC representative or email AskResearch@hsbc.com for more information.

Disclosures & Disclaimer
This report must be read with the disclosures and the analyst certifications in the Disclosure appendix, and with the Disclaimer, which forms part of it.

Issuer of report: The Hongkong and Shanghai Banking Corporation Limited

View HSBC Global Research at:
https://www.research.hsbc.com

Corporate Sustainability Reporting Directive

Last year, the European Commission(EC) adopted a *proposal for a Corporate Sustainability Reporting Directive (CSRD)*, amending the requirements of the *Non-Financial Reporting Directive (NFRD)* which stipulates the disclosure rules on environmental and social matters. The CSRD aims to improve sustainability reporting and ensure adequate public access to information related to financial risks and the environmental/social impacts arising from sustainability issues. Regarding the sustainability reporting requirements, the proposal primarily suggests i.) **scope extension**, ii.) **assurance of sustainability information**, and iii.) **alignment to the EU Sustainability Reporting Standards (ESRS)**.

All large companies and listed companies in the EU would be required to report sustainability information

Wider scope: The CSRD proposes to extend the reporting requirements to all large companies with an average number of employees of more than 500 and listed companies in EU regulated markets with an exception for micro-enterprises[1]. The impact assessment of the proposal estimates approximately 49,000 companies would be required to report sustainability information under the new Directive, while the existing NFRD only covers around 11,600 companies currently.

Assurance: The proposal also requires the statutory auditor to at least perform a 'limited assurance engagement' on a company's sustainability reporting, i.e. to express an opinion of the compliance with the ESRS, the report preparing process, the sustainability information and indicators reported pursuant to Taxonomy Regulation.

Alignment: In order to ensure the comparability and adequacy of the sustainability information, the Directive requires companies to report against the ESRS which provides reporting requirements and standardised indicators. The Standards are expected to be adopted by the Commission this year.

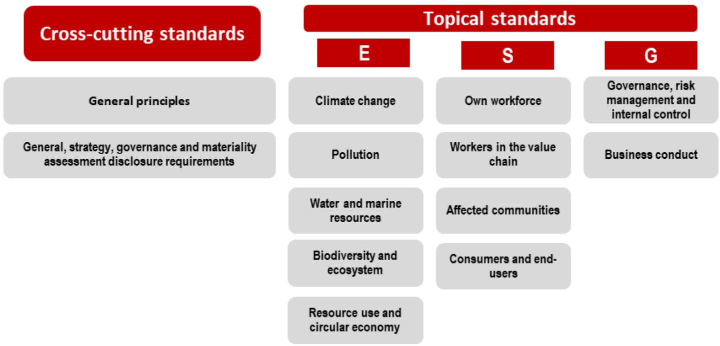
EU Sustainability Reporting Standards

The consultation: On 29 April 2022, the European Financial Reporting Advisory Group (EFRAG) launched a public consultation on the draft ESRS with a deadline of 8 August 2022. The consultation is organised in three sections: i) the overall architecture of the proposed ESRS, ii) the ESRS implementation prioritisation or phasing-in, iii) the adequacy of disclosure requirements, in order to ensure the balance between full alignment to CSRD and stakeholders' expectations.

The standards: The draft standards comprise 2 cross-cutting standards and 11 topical standards across environment, social and governance topics (Figure 1). The cross-cutting standards are applicable to all sectors and companies, and should follow the reporting principles and general reporting requirements stated in the cross-cutting standards. The topical standards set disclosure requirements such as polices, targets, action plans, and performance management on a variety of sustainability topics from a sector agnostic perspective. Companies should report against all topics that are deemed to be material to them and explain any exclusions.

1 According to Article 3 of the Accounting Directive (2013/34/EU), micro-undertakings as undertakings which on their balance sheet dates do not exceed the limits of at least two of the three following criteria: (a) balance sheet total: EUR 350 000; (b) net turnover: EUR 700 000; (c) average number of employees during the financial year: 10.

Figure 1:Overview of draft ESRS



Source: EFRAG

The ESRS would make the EU sustainability initiatives more complete

Progressing towards a more holistic sustainability strategy

The draft ESRS interlinks with other EU sustainability initiatives such as the EU Emissions Trading System (ETS), the EU Taxonomy and the Sustainable Finance Disclosure Regulation (SFDR). The system for the EU Green Deal and the European sustainable finance strategy is advancing towards completion, in our view. The interconnected EU initiatives would complement each other and boost the overall effectiveness of the EU's sustainability objectives. For example, enhanced corporate disclosure would make the preparation of SFDR filings and investment analysis of financial institutions more efficient and comprehensive.

Figure 2: How the ESRS interacts with other EU sustainability initiatives

EU sustainability initiative	Connection
EU ETS	• Mandatory disclosure of share of scope 1 GHG emissions under the EU ETS • Preferred disclosure of potential future liability derived from the EU ETS
EU Taxonomy	• Mandatory disclosure of information on proportion of the turnover, capital expenditure and operating expenditure or on green asset ratio associated with the activities under the EU Taxonomy
SFDR	• The ESRS covers all SFDR Principal Adverse Impacts Indicators

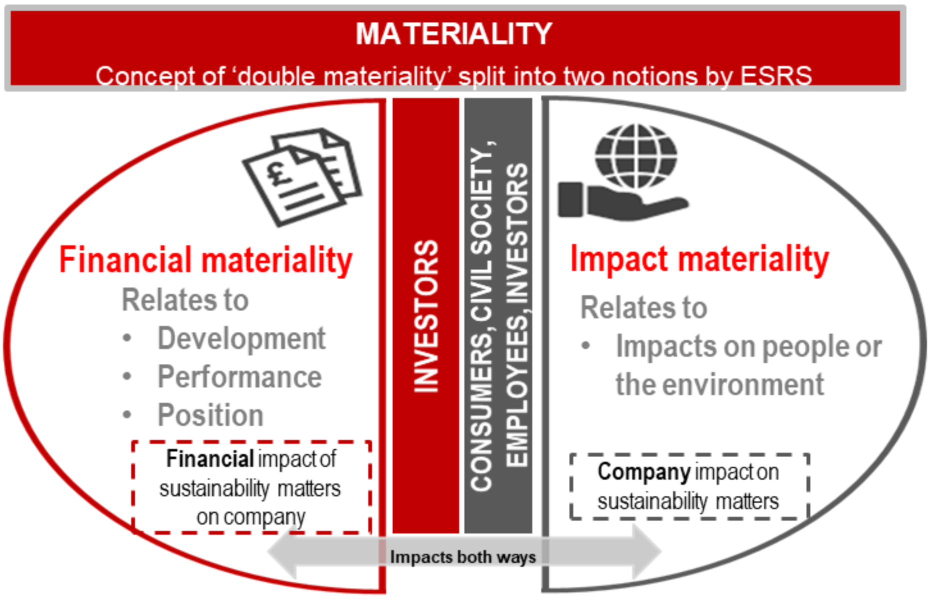
Source: EFRAG, HSBC

Financial and sustainability impacts disclosure could promote ESG integration

Double materiality enhances ESG integration

Following the underlying principles of the NFRD, the ESRS adopts the principle of double materiality, a combination of impact materiality and financial materiality. ***Impact materiality*** is connected to actual or potential significant impacts by companies on society or the environment over any timeframe. ***Financial materiality*** is associated with the financial effects of a sustainability issue or topic. The draft standards of the International Sustainability Standards Board (ISSB) are more financial materiality-focused. Both types of materiality should be determined by the severity and likelihood of the potential impacts. We believe sustainability and financial impacts are intertwined and can mutually affect each other as well as company valuation (while most ESG scoring/ratings focus only on financial materiality). Double materiality-based reports could facilitate the ESG integration process.

Figure 3: Definition of double materiality



Source: HSBC

Forward-looking report

The proposed ESRS emphasise the details of targets and action plans across various ESG topics and ensure that policies support the achievement of these targets during a reporting year. For example, ESRS E1 (Climate) requires companies to include the contribution of different decarbonisation levers over time in their GHG emissions reduction targets. We believe ESG issues would affect the future course of a company. The draft standards could enhance the *forward-looking* analysis of decisions made by investors and other stakeholders.

Beyond TCFD

More rigorous and specific climate disclosure

In 2019, the Commission published non-binding TCFD-aligned Guidelines on reporting climate-related information in order to complement the NFRD. In the draft ESRS, the EFRAG not only include all recommended disclosures of the TCFD but also urge companies to synchronise their climate ambition with the EU as companies would be required to disclose a transition plan that is aligned to the climate neutral economy under the climate goal of limiting global warming to 1.5°C. In addition to climate strategy, the standards require more detailed disclosure of climate action plans and metrics such as ***locked-in emissions*** (estimate of future GHG emissions), ***scope 3 emissions*** and the financial implications of climate risks.

In our view, this proposal is the most robust mandatory climate disclosure regime proposed so far and it has the potential to set a new level for climate disclosure worldwide. It requires companies to further incorporate climate factors into their business plans. Companies have to quantify the financial impacts of climate risk by estimating the potential liability of the EU ETS, the potential value of stranded assets, cash flows derived from the EU Taxonomy and future financial effects of material climate risks. We think investors would be better positioned to understand the climate risks and opportunities embedded in their portfolios.

Figure 4: The ESRS asks for stricter climate disclosure than the TCFD recommendations

Elements of TCFD recommendation	Additional disclosure requirements of the ESRS
Governance	• Climate-related incentive schemes (e.g. remuneration policy and internal carbon pricing scheme)
Strategy	• Transition plan to a climate neutral economy and with limiting global warming to 1.5°C • Calculation methodology, data and management of locked-in GHG emissions from products and assets • Cross-reference to the financial statement • Plan for future Taxonomy alignment
Risk management	• More detailed and specific requirements for climate risk identification and assessment
Metrics and target	• Energy consumption, mix and intensity per revenue • Share of scope 1 emissions under EU ETS • Scope 3 emissions by category ((i) upstream purchasing, (ii) downstream sold products, (iii) goods transportation, (iv) travel and (v) financial investments.) • Absolute GHG emissions target • Cash flow (e.g. turnover, CapEx, OpEx) from the EU Taxonomy • Scope of net zero target • Potential financial effects from its material physical and transition risks (e.g. stranded assets and potential liability relating to EU ETS) • Taxonomy-alignment ratio

Source: EFRAG, HSBC

A first for biodiversity disclosure

The standards suggest three mandatory metrics in biodiversity disclosure

The absence of standardised biodiversity-related metrics has been a challenge for companies and investors as they try to track and monitor the progress of biodiversity- or nature-related investment. In this regard, the draft ESRS requires companies to disclose measurable targets on avoidance, reduction and restoration of biodiversity loss and three performance metrics – pressure, impact and response (Figure 5). Although the biodiversity disclosure standards are still mostly principle-based, we see a breakthrough in nature disclosure with the provision of a framework for setting measurable targets and metrics. We believe the Standards could stimulate the development of other markets' disclosure and the nature-related disclosure framework by the Taskforce on Nature-related Financial Disclosures(TNFD) which released a beta framework in March 2022.

Similar to the climate standards, the draft standards require companies to follow the EU's biodiversity strategy and the Post-2020 Global Biodiversity Framework draft by mandating them to disclose their plan to achieve 'no net loss by 2030', 'net gain from 2030' and 'full recovery by 2050', aligning to the EU's strategy. We think this would bolster the biodiversity commitment and awareness of companies, resulting in a gradual change in market sentiment towards biodiversity.

Figure 5: Mandatory disclosure metrics

Metric	Definition	Example
Pressure	Material impact drivers that unequivocally influence biodiversity, ecosystem services and underlying ecosystem	Area of forest or grassland converted due to urbanisation
Impact	Progress of the companies towards no net loss and net gain in biodiversity	Number of a bird species of interest within a specific area
Response	How the companies minimise, rehabilitate or restore material impacts on biodiversity and ecosystem	Area of forest protected or restored

Source: EFRAG, HSBC

Reiterating value chain

More regulations in value chain management are anticipated

In a 2019 report, we suggested the climate reporting guidelines were the beginning of a shift in responsibility across the value chain of a company and its products. We think the draft ESRS further reflects the significance of value chain management as more disclosure requirements on value chain management ranging from scope 3 emissions (value chain emissions) to workers in the value chain. In our view, regulators might ask companies to take up more responsibility on sustainability practices throughout their value chains in the coming years as seen in the *proposal for corporate sustainability due diligence* in February 2022 and the enhanced disclosure rule.

Gig workers matter

Companies would be required to disclose the number of gig workers

Discussions about the employment status, legal protection and welfare of gig workers have been growing since the rise of the gig economy. In light of the potential dispute between platform companies, employees and regulators, the EFRAG proposes that companies shall disclose the number of non-employee workers in their workforce including self-employed workers and workers engaged in related “employment activities”. Non-employee workers are also included in several mandatory requirements along with employees, such as labour policies, training indicators and fair remuneration, indicating the growing awareness and significance of gig workers or non-employee workers. We think the proposal could enhance the transparency of non-employee workers working conditions and treatment, identifying the underlying risks related to labour practices.

Yaryna Kobel
Corporate Governance Analyst
HSBC Bank plc

Progression in corporate governance

Since the consultation on sustainable corporate governance requirements and the adoption of the corporate sustainability due diligence proposal, sustainability and corporate governance practices seem to be inseparable. We think the disclosure requirements would fill some gaps in the sustainable governance proposal.

EU should do more on companies’ succession planning, in our view

For **nomination and selection** of the governance bodies, we think the required disclosure on the process and criteria such as diversity and independence would be positive to companies’ governance practices. However, these disclosures should be part of broader disclosures on succession planning which is not mentioned in the draft standards. Succession planning disclosure enables investors to identify the risk of unexpected leadership exits as poor succession of the executives could have business interruption and sequential financial impacts on the company.

Diversity policy requirement should avoid “diversity washing”

Diversity has been a focus in corporate governance as it can reduce the risk of groupthink, optimise board decision-making and improve company performance. The draft ESRS proposes companies shall disclose their diversity policy applied in relation to governance bodies regarding gender, age, minority or vulnerable group, education and professional background and other aspects where relevant. We suggest the word order should be changed to “relevant aspects which may include…” to avoid a random collection of “diverse” people in the board or management bodies. Those positions should not be filled for the sole purpose of fulfilling diversity targets, which might result in “diversity washing”. We think boards should be thoughtful in adding diversity that supports company ESG commitments, stakeholder and strategic objectives; thus, we think, they should disclose information on diversity aspects which are most relevant to them but it should not be a box checking practice.

Disclosure of evaluation process and action would benefit corporate governance practices

The draft standards require companies to disclose the process for **evaluating the performance of the governance bodies** and actions taken in response to the evaluation. We believe this would provide investors with greater visibility as to how and when board reviews are conducted. Nevertheless, we suggest the requirements should be more specific, ensuring the review adds values and provides investors with insight into board strengths and weaknesses. The standards should require the objective and scope of the evaluation to be disclosed as a minimum, including whether it was a comprehensive review of all aspects of the board's effectiveness or focused on particular factors; if externally facilitated, an explanation should also be provided where the reviewer has any other connections with the company; outcomes or progress of the actions taken regarding the evaluation results.

Company purpose and culture are not well addressed in the draft

In general, we think the proposed standards are positive for corporate governance practices but still have room for improvement. We notice that company purpose and culture is not well addressed. The draft requires "a description of the mission, vision and core values of the undertaking, when defined as such, and of the goals and purposes of the undertaking's in terms of product and services…". We, however, think "purposes" here is referring to business model in context rather than the reason for the existence of a company beyond profits. We think purpose and culture can help not only to promote better social and environmental outcomes but also lead to effective decision-making and better financial performance.

What next

After the public consultation for the proposed EU Sustainability Reporting Standards, the Commission is expected to adopt the standards by 31 October 2022. SME-proportionate standards nor sector-specific standards are not included in this draft but are anticipated to be released next year as the CSRD requires the Commission to adopt a set of standards that specify "information specific to the sector in which a company operates" and "sustainability reporting standards for small and medium sized companies" by 31 October 2023.

For the legislative process of the CSRD, the European Council[2] and the Legal Affairs Committee of the European Parliament[3] adopted their position on the CSRD in February and March 2022 respectively. The talks with the EU Member States could start after the Parliament approve its position on the Directive as a whole.

Proposed deadlines for the CSRD by the European Council

Date	Action
31 October 2022	Adoption of the general standards
31 October 2023	Adoption of sector-specific standards and standards for SMEs
1 January 2024	Implementation by companies already subject to the NFRD (reporting in 2025 on 2024 data)
1 January 2025	Implementation by large companies not subject to the NFRD currently (reporting in 2026 on 2025 data)
1 January 2026	Implementation by listed SMEs (reporting in 2027 on 2026 data)

Source: European Council

2 European Council (2022), Council adopts its position on the corporate sustainability reporting directive (CSRD)
3 European Parliament (2022), Companies to be more accountable for their social and environmental impact

Disclosure appendix

The following analyst(s), who is(are) primarily responsible for this document, certifies(y) that the opinion(s), views or forecasts expressed herein accurately reflect their personal view(s) and that no part of their compensation was, is or will be directly or indirectly related to the specific recommendation(s) or views contained in this research report: Polo Heung, Wai-Shin Chan, CFA and Yaryna Kobel

This document has been issued by the Research Department of HSBC.

HSBC and its affiliates will from time to time sell to and buy from customers the securities/instruments, both equity and debt (including derivatives) of companies covered in HSBC Research on a principal or agency basis or act as a market maker or liquidity provider in the securities/instruments mentioned in this report.

Analysts, economists, and strategists are paid in part by reference to the profitability of HSBC which includes investment banking, sales & trading, and principal trading revenues.

Whether, or in what time frame, an update of this analysis will be published is not determined in advance.

For disclosures in respect of any company mentioned in this report, please see the most recently published report on that company available at www.hsbcnet.com/research.

Additional disclosures

1. This report is dated as at 12 May 2022.
2. All market data included in this report are dated as at close 12 May 2022, unless a different date and/or a specific time of day is indicated in the report.
3. HSBC has procedures in place to identify and manage any potential conflicts of interest that arise in connection with its Research business. HSBC's analysts and its other staff who are involved in the preparation and dissemination of Research operate and have a management reporting line independent of HSBC's Investment Banking business. Information Barrier procedures are in place between the Investment Banking, Principal Trading, and Research businesses to ensure that any confidential and/or price sensitive information is handled in an appropriate manner.
4. You are not permitted to use, for reference, any data in this document for the purpose of (i) determining the interest payable, or other sums due, under loan agreements or under other financial contracts or instruments, (ii) determining the price at which a financial instrument may be bought or sold or traded or redeemed, or the value of a financial instrument, and/or (iii) measuring the performance of a financial instrument or of an investment fund.

Disclaimer

This document has been issued by The Hongkong and Shanghai Banking Corporation Limited, which has based this document on information obtained from sources it believes to be reliable but which it has not independently verified. Neither The Hongkong and Shanghai Banking Corporation Limited nor any member of its group companies ("HSBC") make any guarantee, representation or warranty nor accept any responsibility or liability as to the accuracy or completeness of this document and is not responsible for errors of transmission of factual or analytical data, nor is HSBC liable for damages arising out of any person's reliance on this information. The information and opinions contained within the report are based upon publicly available information at the time of publication, represent the present judgment of HSBC and are subject to change without notice.

This document is not and should not be construed as an offer to sell or solicitation of an offer to purchase or subscribe for any investment or other investment products mentioned in it and/or to participate in any trading strategy. It does not constitute a prospectus or other offering document. Information in this document is general and should not be construed as personal advice, given it has been prepared without taking account of the objectives, financial situation or needs of any particular investor. Accordingly, investors should, before acting on it, consider the appropriateness of the information, having regard to their objectives, financial situation and needs. If necessary, seek professional investment and tax advice.

The decision and responsibility on whether or not to purchase, subscribe or sell (as applicable) must be taken by the investor. In no event will any member of the HSBC group be liable to the recipient for any direct or indirect or any other damages of any kind arising from or in connection with reliance on any information and materials herein.

Past performance is not necessarily a guide to future performance. The value of any investment or income may go down as well as up and you may not get back the full amount invested. Where an investment is denominated in a currency other than the local currency of the recipient of the research report, changes in the exchange rates may have an adverse effect on the value, price or income of that investment. In case of investments for which there is no recognised market it may be difficult for investors to sell their investments or to obtain reliable information about its value or the extent of the risk to which it is exposed. Some of the statements contained in this document may be considered forward looking statements which provide current expectations or forecasts of future events. Such forward looking statements are not guarantees of future performance or events and involve risks and uncertainties. Actual results may differ materially from those described in such forward-looking statements as a result of various factors.

This document is for information purposes only and may not be redistributed or passed on, directly or indirectly, to any other person, in whole or in part, for any purpose. The distribution of this document in other jurisdictions may be restricted by law, and persons into whose possession this document comes should inform themselves about, and observe, any such restrictions. By accepting this report, you agree to be bound by the foregoing instructions. If this report is received by a customer of an affiliate of HSBC, its provision to the recipient is subject to the terms of business in place between the recipient and such affiliate. The document is intended to be distributed in its entirety. Unless governing law permits otherwise, you must contact a HSBC Group member in your home jurisdiction if you wish to use HSBC Group services in effecting a transaction in any investment mentioned in this document.

Certain investment products mentioned in this document may not be eligible for sale in some states or countries, and they may not be suitable for all types of investors. Investors should consult with their HSBC representative regarding the suitability of the investment products mentioned in this document.

HSBC and/or its officers, directors and employees may have positions in any securities in companies mentioned in this document. HSBC may act as market maker or may have assumed an underwriting commitment in the securities of companies discussed in this document (or in related investments), may sell or buy securities and may also perform or seek to perform investment banking or underwriting services for or relating to those companies and may also be represented on the supervisory board or any other committee of those companies.

From time to time research analysts conduct site visits of covered issuers. HSBC policies prohibit research analysts from accepting payment or reimbursement for travel expenses from the issuer for such visits.

The Hongkong and Shanghai Banking Corporation Limited is regulated by the Hong Kong Monetary Authority.

© Copyright 2022, The Hongkong and Shanghai Banking Corporation Limited, ALL RIGHTS RESERVED. No part of this publication may be reproduced, stored in a retrieval system, or transmitted, on any form or by any means, electronic, mechanical, photocopying, recording, or otherwise, without the prior written permission of insert issuing entity name. MCI (P) 037/01/2022, MCI (P) 017/10/2021

[1192565]